Debt vs Equity

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# **Introduction**

Decision of financing is a key for successful launch and operations of any business. There are pros and cons to both equity and debt which have to be considered when deciding on mode of financing. An analysis of financial reports with the help of financial ratios is required to help companies to assess debt and equity options. This report assesses Woolworths and Jbhi-fi companies over a period of three years to assess equity and debt sections.

# **Equity**

Equity is the residual interest in resources of a company that is left after subtracting liabilities which means that ownership interest in any company is called equity which is calculated as a difference between assets and liabilities. Equity is affected by net income or loss as businesses operate over a period of time. A corporation is a business entity that has a different legal identity from its owners. In the balance sheets of both companies, first item of equity section is contributed capital which includes the results of various stock transactions undertaken by a company during a year (Cengage). Reserves are amounts of money which have been kept for some capital expenditure in future. Retained earnings is that part of profit which has been kept by organization to pay dividends etc. For Woolworths, contributed equity has decreased from 2018 to 2019 because in 2018, company had issued more shares as a part of dividend reinvestment plan as compared to 2019. Over a period of 2017 to 2018, there was an increase in total equity for the company. This increase was primarily due to increase in number of shares issued by the company (Woolworths, 2017). For Jbhifi, there has been a minimal decrease in contributed equity from 2018 to 2019 which is due to a small number of shares acquired by employee share trust. From 2017 to 2018, there has been an increase in equity for the company because company had issued more shares to its shareholders (Jbhifi, 2019).

# **Reserves**

Reserves are amounts kept aside by companies to meet some future obligations. Capital and revenue reserves are two major kinds which are relevant to financial statements. Capital reserves are kept for some capital expenditure to be incurred in future and this amount cannot be used to pay out dividends to shareholders whereas revenue reserves can be used to pay out dividends to shareholders. For Woolworths, there has been an increase in amount of reserves from the period of 2018 to 2019. The major increase has been seen in the foreign currency translation reserve. The translation of foreign currency has been profitable in the year 2019 as opposed to 2018. From 2017 to 2018, there has been a considerable increase in amount of reserves because company has a large number of classifications of reserves (JbHi-fi, 2018). Except for foreign currency translation reserves, all other reserves have increased in value. Amount of reserves for Jbhifi has also increased from 2018 to 2019. The major cause of this increase is a higher amount in terms of equity settled benefits. This form of reserve is used to show grant of share options to executive and non-executive management following share option plans of company. There is a difference between price consideration of non-controlling interest and its closing balance at any given point in time and in particular at a date on which change of ownership occurs, this difference is recorded as common control reserves. Hedging reserves arise out of any forward contracts taken on by the company. Foreign currency translation means that foreign controlled entities will be converted to Australian dollar. Among all these items, equity settled benefits and foreign currency translation reserves have increase from 2018 to 2019.

# **Debt**

Another source of finance for companies is debt which is often known as liabilities in annual financial statements of a company. The companies under consideration have managed to decrease the amount of short-term debt or liabilities from 2018 to 2019. For Woolworths, major decrease has been noted in trade and other payables and borrowings. Trade and other payables are amounts which a business owes as a result of normal operations of business e.g. suppliers to whom payments have to be made on monthly basis. Provisions are amounts of money set aside by a company to account for certain happenings in the short run. A classic example of reserve is the reserve for depreciation. Borrowings have been increased largely due to short term unsecured securities. There has also been an increase in long term unsecured securities for the company. For Jbhifi, there has been a decrease in borrowings because business has revised the terms of its borrowing agreements with banks. Further analysis reveals that there has been a slight increase in total current liabilities for the company with primary increase in deferred revenues. These are advance amounts received from customers who will be offered services after some time. This amount is also called unearned revenue. There has been a decrease in long term liabilities with a major decrease in borrowings section which has already been discussed. There has been a decrease in all items of long-term liabilities except for other non-current liabilities which have increased. There has been considerable increase in employee benefits offered by the company both in short and long terms. Similarly, lease provisions have also increased in short and long terms.

Debt means borrowing money and debt financing means to finance any business with the help of debt or loans taken from others. This way of financing will mean that businesses will not have to sacrifice their control over business to get finance for their business. Debt finance means that businesses will have to pay both interest and principal to the party from whom they have taken the loans. If there are any problems due to which, creditor is unable to fulfil their commitments, it may result in serious consequences. There is a predetermined rate of interest and time period for maturity of loan. There are other options for debtors to pay off debt, one of most common settlement is to payback in part payments. Large businesses also issue bonds which have the same characteristics as all other loans have. Debt financing can be secured or unsecured in nature. A secured loan is backed by a guarantee that loan will be paid off. Security may not necessarily be a physical asset, some lenders lend money to businesses on their goodwill or name only (Whitley, 2017).

# **Debt Vs Equity**

There is always a need of additional cash for business for the purpose of growth and investment. Taking too much debt may affect liquidity ratios of a business. Businesses have another option to accumulate funds from general public and that is in the form of equity. Equity financing comes in form of share issued by businesses for sale to public. Using this method will mean that some control over the business has to be sacrificed and given to shareholders. Equity financing will mean that risk of failure is also distributed over the number of owners or shareholders. Shareholders have to be paid in form of dividends which means that they will have some right over the future profits of the company in name of dividends paid by company to shareholders. With the inception of shareholders, these people also become interested in an increasing value of company shares. Company performance has a positive impact on shareholder’s value but a company has to take all stakeholders along while making any decision. The companies discussed have increased their amounts of equity and reduced liabilities of debts. This means that they will not have to pay any interest to creditors but have to share the control and ownership with shareholders. This share of control will mean that shareholders are able to ask the management about any decision taken. Decrease in debt will mean that companies will have a little less amount of expenses to be made. Another positive aspect of equity is that it is not compulsory for companies to pay dividend to their shareholders but there is no way that companies can postpone payment of interest to creditors. In my opinion, companies have done well to decrease debt and increase equity. The risks associated with equity financing are borne completely by investors. This means that owners and company are two different legal entities, if desired results are not achieved and there is a loss, company will not have to bear it and it will not pay anything to shareholders. For shareholders, limited liability is a benefit of investing in companies as opposed to sole proprietorship or partnership. There is a higher amount of cash available to the company in the absence of any loans to pay back. This excess cash can be invested in business to pursue new growth opportunities. Sharing of ownership is the biggest disadvantage of equity financing which will mean that management will have lesser control over various decisions to be made. Raising equity capital is a complex process as compared to obtaining a loan. There are a large number of documents which have to be put up with authorities to make sure that company can issue equity shares (R.Graham, 2006).

# **Part** **B**

## **Small and large proprietary company**

A company whose shares may not be offered for sale to general public. A small proprietary company is the one having a consolidated revenue for any financial year that is less than $ 50 million (Buck, 2019). The value of its gross assets is less than $ 25 million and the number of employees kept by the entity and its subsidiaries is less than 100. A proprietary company is registered or converted to this status under the corporation’s act 2001, section 45 A (austlii.edu.au). For registration, section 118 or 601BD will be used whereas for conversion, part 2 B.7 has to be adopted. A proprietary company can be limited by shares or it can be an unlimited company with share capital. There cannot be more than 50 shareholders and this figure does not include employee shareholders and those shareholders which are connected to CSF offer are not included in this count. There is no need for the proprietary companies to disclose their operations in the form of financial statements and the shareholders also have no right to ask for these statements. A small proprietary company has reduced requirements of financial disclosure. There are different sections in law that govern annual and half yearly financial statements. Section 296 governs the annual financial statements that is not required from small proprietary companies. This means that financial data of small proprietary companies does not require to follow certain accounting standards if the report is prepared in response to directions from shareholders and direction specifies that report does not have to comply with these particular standards. There are some small companies which are limited by guarantee and financial statements of these companies do not have to comply with certain accounting standards if these financial statements are prepared in response to directions given by a member and these directions specify that company does not have to comply with these standards.

## **Large proprietary company**

A large proprietary company is the one that has a consolidated revenue for any financial year that is greater than or equal to $ 50 million. The value of its consolidated gross assets at the end of financial year is more than or equal to $ 25 million. Company and its entities combined have employees who are more than 100 in number. Accounting standards have to followed to calculate the value of revenues and relevant assets for purpose of this regulation.

## **Reporting Entity**

A reporting entity is a business whose financial statements are expected to be used by outside people for various purposes. These decisions will be based on financial position of the company. Various stakeholders will have different uses of these financial statements. The most important users of these financial statements are the shareholders who use these statements to see if dividends will be paid to them or not. The second use of financial statements for shareholders is to see if the value of shares has gone up or not. People who can be prospective shareholders of an entity may be interested in taking a view of past performance of the company to decide whether they should invest in this entity or not. The shareholders will also oversee general operations of entity to see if there has been reasonable amount of debt and capital has been used. Excessive use of debt will mean that shareholders may not be able to get much dividends. Any investors other than shareholders will also be interested in taking a look on financial statements because he or she will want to earn a reasonable return on the invested amount. Return on investment is one important ratio which an investor will consider while assessing the financial statements of a company. Cash flow statement is another part of financial statements that will be assessed by investors to know if the company is able to produce enough cash to pay a reasonable return to investors. If the investor is in the form of a lender, he will assess the company by seeing creditors turnover ratio which shows how many times an entity can pay off its creditors and how many days will the company take to pay off creditors on average. Employees is another part of organization who will be interested in financial statements to see and compare the profits earned by company with salaries and bonuses paid to them. Creditors are interested in various liquidity ratios especially those which are related to current assets and current liabilities. Liquidity ratios will show the ability of firms to convert their resources to cash. A current ratio of 1.5 will mean that for each dollar of current liabilities, there are 1.5 dollars of current assets which means that firm will be left with $ 0.5 after paying each dollar of current liability. This means that creditors will be assured to get their payments on time. Government will also be interested in financial statements of an entity because of tax calculations. Some other agencies will see statements whether all required accounting principles are properly followed or not. In the modern business era, governments are also concerned with compliance of governance issues by companies (Bull, 2008).

With so many users looking at the financial statements from various angles, there is an increased responsibility on company management to prepare such reports with utmost care and responsibility. First step is to define an entity as reporting or non-reporting. Next step will be to describe the financial reporting framework to be used by the company. Some examples may include listed public companies, large private companies with external shareholders and educational institutions. In case of a reporting entity, all Australian accounting standards have to be applied by this form of company. There is a risk that an entity is wrongly defined as a non-reporting entity whereas it fulfils the characteristics of a reporting company. If there is such a case, Australia’s Securities and Investment Commission will investigate the matter with those who are overseeing the company (Fermanis, 2017).

# **Conclusion**

In case of above two companies, it is better for them to issue shares and minimise their level of debt. As far as the form of business organisation is concerned, reporting entity is the best option. The reason for this choice is that shareholders will need a large amount of information to make investment decisions and this information will be taken up from financial reports. All other stakeholders will also be able to take well informed decisions based on financial information in reports.

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