The Nature of Liabilities

Defined as debts or obligations arising from past transactions or events.

Maturity = 1 year or less

Current Liabilities

Maturity > 1 year

Noncurrent Liabilities
Distinction Between Debt and Equity

The acquisition of assets is financed from two sources:

**DEBT**
Funds from creditors, with a definite due date, and sometimes bearing interest.

**EQUITY**
Funds from owners.
Estimated Liabilities

Estimated liabilities have two basic characteristics:

1. The liability is *known to exist*,
2. The precise dollar amount *cannot be determined* until a later date.

Example: An automobile warranty obligation.
Current Liabilities: Accounts Payable

Short-term obligations to suppliers for purchases of merchandise and to others for goods and services.

Examples:

- Merchandise inventory invoices
- Office supplies invoices
- Shipping charges
- Utility and phone bills
When a company borrows money, a note payable is created.

**Current Portion of Notes Payable**
The portion of a note payable that is due within one year, or one operating cycle, whichever is longer.
PROMISSORY NOTE

Miami, Fl  Nov. 1, 2011
Location  Date

Six months after this date  Porter Company

promises to pay to the order of  Security National Bank

the sum of  $10,000.00  with interest at the rate of  12.0%  per annum.

Signed:  John Caldwell
Title:  Treasurer and Senior VP
Accrued Liabilities

Accrued liabilities arise from the recognition of expenses for which payment will be made in the future. Accrued liabilities are often referred to as accrued expenses.

Examples include:
1. Interest payable,
2. Income taxes payable, and
3. Accrued payroll liabilities.
Payroll Liabilities

Gross Pay

Less Deductions:

- Social Security and Medicare
- Workman’s Compensation
- Federal Income Tax
- State and Local Income Taxes
- Voluntary Deductions

Net Pay
Deferred revenue is recorded.

Cash is sometimes collected from the customer before the revenue is actually earned.

As the earnings process is completed

Cash is received in advance.

Deferred revenue is recorded.

Earned revenue is recorded.

a liability account.
Relatively small debt needs can be filled from single sources.

- Banks
- Insurance Companies
- Pension Plans
Long-Term Liabilities

Large debt needs are often filled by issuing bonds.
One special type of long-term liability is an obligation that will mature in the current period but that is expected to be refinanced on a long-term basis.

If management has both the intend and ability to refinance soon-to-mature obligations on a long-term basis, these obligations are classified as long-term liabilities.
Installment Notes Payable

Long-term notes that call for a series of installment payments.

Each payment covers interest for the period AND a portion of the principal.

With each payment, the interest portion gets smaller and the principal portion gets larger.
Allocating Installment Payments Between Interest and Principal

1. Identify the unpaid principal balance.
2. Interest expense = Unpaid Principal × Interest rate.

On January 1, Year 1, King’s Inn purchased furnishings at a cost of $7,581.57. The loan was a five-year loan and had an interest rate of 10%. The annual payment is $2,000.

Let’s prepare an amortization table for King’s Inn.
## Preparing an Amortization Table

<table>
<thead>
<tr>
<th>Date</th>
<th>Payment</th>
<th>Interest Expense</th>
<th>Reduction in Unpaid Balance</th>
<th>Unpaid Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan 1, Year 1</td>
<td>$2,000.00</td>
<td>$758.16</td>
<td>$1,241.84</td>
<td>$7,581.57</td>
</tr>
<tr>
<td>Dec. 31, Year 1</td>
<td>$2,000.00</td>
<td></td>
<td>$1,241.84</td>
<td>6,339.73</td>
</tr>
<tr>
<td>Dec. 31, Year 2</td>
<td>$2,000.00</td>
<td>633.97</td>
<td>1,366.03</td>
<td>4,973.70</td>
</tr>
<tr>
<td>Dec. 31, Year 3</td>
<td>$2,000.00</td>
<td>497.37</td>
<td>1,502.63</td>
<td>3,471.07</td>
</tr>
<tr>
<td>Dec. 31, Year 4</td>
<td>$2,000.00</td>
<td>347.11</td>
<td>1,652.89</td>
<td>1,818.18</td>
</tr>
<tr>
<td>Dec. 31, Year 5</td>
<td>$2,000.00</td>
<td>181.82</td>
<td>1,818.18</td>
<td>0.00</td>
</tr>
</tbody>
</table>

$7,581.57 \times 10\% = $758.16

$2,000 - 758.16 = $1,241.84

$7,581.57 - 1,241.84 = $6,339.73
The information needed for the journal entry can be found on the amortization table. The cash payment amount, the interest expense, and the principal reduction amount are all in the table.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31</td>
<td>Interest Expense</td>
<td>758.16</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest Payable</td>
<td></td>
<td>758.16</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
On January 1, Year 2, the first annual payment will be made on the installment note. Refer to the previous entry and amortization for the amounts shown.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1</td>
<td>Interest Payable</td>
<td>758.16</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Note Payable</td>
<td>1,241.84</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td>2,000.00</td>
</tr>
</tbody>
</table>
Bonds Payable

• Bonds usually involve the borrowing of a large sum of money, called **principal**.

• The principal is usually paid back as a **lump sum** at the end of the bond period.

• Individual bonds are often denominated with a par value, or **face value**, of $1,000.
Bonds Payable

- Bonds usually carry a stated rate of interest, also called a **contract rate**.
- Interest is normally paid semiannually.
- Interest is computed as:

  \[ \text{Principal} \times \text{Stated Rate} \times \text{Time} = \text{Interest} \]
Bonds Payable

- Bonds are issued through an intermediary called an **underwriter**.
- Bonds can be sold on organized securities exchanges.
- Bond prices are usually quoted as a **percentage** of the face amount.

For example, a $1,000 bond priced at 102 would sell for $1,020.
Types of Bonds

- Mortgage Bonds
- Debenture Bonds
- Convertible Bonds
- Junk Bonds
On March 1, 2011, Wells Corporation issues $1,500,000 of 12%, 10-year bonds payable. Interest is payable semiannually, each March 1 and September 1. Assume the bonds are issued at face value. Record the issuance of the bonds.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar. 1</td>
<td>Cash</td>
<td>1,500,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bonds Payable</td>
<td></td>
<td>1,500,000</td>
</tr>
</tbody>
</table>
Record the interest payment on September 1, 2011.

$1,500,000 \times 12\% \times \frac{1}{2} = $90,000

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sep. 1</td>
<td>Interest Expense</td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td>90,000</td>
</tr>
</tbody>
</table>
Bonds Issued Between Interest Dates

- Bonds are often sold between interest dates.
- The selling price of the bond is computed as:

\[
\text{Present value of the bond} + \text{Accrued interest since the last interest payment} = \text{Selling price of the bond}
\]
Bonds Issued at a Discount or a Premium

The selling price of the bond is determined by the market based on the time value of money.

<table>
<thead>
<tr>
<th>Stated interest rate is</th>
<th>The bonds sells:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Above market rate</td>
<td><strong>At a premium</strong></td>
</tr>
<tr>
<td></td>
<td>(Cash received is greater than face amount)</td>
</tr>
<tr>
<td>Equal to market rate</td>
<td><strong>At face amount</strong></td>
</tr>
<tr>
<td></td>
<td>(Cash received is equal to face amount)</td>
</tr>
<tr>
<td>Below market rate</td>
<td><strong>At a discount</strong></td>
</tr>
<tr>
<td></td>
<td>(Cash received is less than face amount)</td>
</tr>
</tbody>
</table>
Bonds Issued at a Discount

Wells, Corp. issues bonds on January 1, 2011.
Principal = $1,000,000
Issue price = $950,000
Stated Interest Rate = 9%
Interest Dates = 6/30 and 12/31
Maturity Date = Dec. 31, 2030 (20 years)

<table>
<thead>
<tr>
<th>Principal</th>
<th>Proceeds</th>
<th>Discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000,000</td>
<td>$950,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>
Bonds Issued at a Discount

To record the bond issue, Well, Inc. would make the following entry on January 1, 2011:

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1</td>
<td>Cash</td>
<td>950,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Discount on Bonds Payable</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bonds Payable</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td><strong>Long-term Liabilities:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>---------------------------</td>
<td>---</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds Payable</td>
<td>$1,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Discount on Bonds Payable</td>
<td>50,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$950,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Maturity Value**

**Carrying Value**
Bonds Issued at a Discount

Amortizing the discount over the term of the bond increases Interest Expense each interest payment period.

Using the **straight-line** method, the discount amortization will be $1,250 every six months.

$50,000 ÷ 40 periods = $1,250
Amortization of the Discount

Interest paid every six months is calculated as follows:

\[ $1,000,000 \times 9\% \times \frac{1}{2} = $45,000 \]

We prepare the following journal entry to record the first interest payment.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jun. 30</td>
<td>Interest Expense</td>
<td>46,250</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Discount on Bonds Payable</td>
<td></td>
<td>1,250</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td>45,000</td>
</tr>
</tbody>
</table>
Bonds Issued at a Discount

Partial Balance Sheet as of December 31, 2011

Long-term Liabilities:
- Bonds Payable $1,000,000
- Less: Discount on Bonds Payable $47,500

The carrying value will increase to exactly $1,000,000 on the maturity date.
Wells Corporation will repay the principal amount on December 31, 2030 with the following entry:

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31</td>
<td>Bonds Payable</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td>1,000,000</td>
</tr>
</tbody>
</table>
The Concept of Present Value

How much is a future amount worth today?
The Concept of Present Value

Two types of cash flows are involved with bonds:

1. Periodic interest payments called annuities.

2. Principal payment at maturity is a lump sum payment.
Early Retirement of Debt

Bonds can be retired by . . .

- Exercising a call provision.
- Purchasing the bonds on the open market.

Gains or losses incurred as a result of retiring bonds should be reported as other income or other expense on the income statement.
Loss Contingencies

An existing uncertain situation involving potential loss depending on whether some future event occurs.

Two factors affect whether a loss contingency must be accrued and reported as a liability:

1. The likelihood that the confirming event will occur.
2. Whether the loss amount can be reasonably estimated.
Evaluating the Safety of Creditors’ Claims

\[
\text{Interest Coverage Ratio} = \frac{\text{Operating Income}}{\text{Interest Expense}}
\]

This ratio indicates a margin of protection for creditors. From the creditor’s point of view, the higher this ratio, the better.
End of Chapter 10