

Financial Accounting

Module 12: Non-Current Liabilities



Module Learning Outcomes

Describe the accounting and reporting of non-current liabilities

- 12.1: Recognize long-term debt financing options
- 12.2: Demonstrate an understanding of bonds payable
- 12.3: Understand accounting for leases
- 12.4: Illustrate proper reporting of non-current liabilities

Long-term Financing

Learning Outcomes: Long-term Financing

12.1: Recognize long-term debt financing options

12.1.1: Evaluate the alternatives for financing on a long-term basis

12.1.2: Record journal entries related to notes payable

12.1.3: Understand the implications of the time value of money

Evaluate the Alternatives for Financing on a Long-Term Basis

Debt Financing. A company uses various kinds of debt to finance its operations. Two major classifications of long-term debt are:

- Secured
- Unsecured

Secured Debt. A debt obligation is considered secured if creditors have recourse to the assets of the company on a proprietary basis or otherwise ahead of general claims against the company.

Unsecured Debt comprises financial obligations, where creditors do not have recourse to the assets of the borrower to satisfy their claims.

Types of Debt. In addition to being either secured or unsecured, debt could be classified as:

- Private
- Public

Record Journal Entries Related to Notes Payable

Notes Payable is a general ledger liability account in which a company records the face amounts of the promissory note that it has issued. The balance in Notes Payable represents the amounts that remain to be paid. The journal entry to record the receipt of the proceeds of the note is fairly straightforward—increase the checking account to reflect the deposit, and increase a long-term liability account called Notes Payable.

JOURNAL				Page 101
Date	Description	Post. Ref.	Debit	Credit
20X1				
Dec 1	Checking Account		100,000	
	Notes Payable			100,000
	To record proceeds from bank loan			

Understand the Implication of the Time Value of Money

Time value of money draws from the idea that rational investors prefer to receive money today rather than the same amount of money in the future because of money's potential to grow in value over a given period of time.

Depending on the exact situation in question, the time value of money formula may change slightly. For example, in the case of annuity payments, the generalized formula has additional or less factors.



Understand the Implication of the Time Value of Money

The most fundamental TVM formula takes into account the following variables:

FV = Future value of money

PV = Present value of money

i = interest rate

n = number of compounding periods per year

t = number of years

Based on these variables, the formula for TVM is:

$$\mathbf{FV = PV \times [1 + (i / n)] (n \times t)}$$

Bonds Payable

Learning Outcomes: Bonds Payable

12.2: Demonstrate an understanding of bonds payable

12.2.1: Identify various types of bonds

12.2.2: Record the entries associated with a bond issue sold at face value

12.2.3: Determine the items that impact the selling price of a bond

12.2.4: Record the entries for a bond issue sold at a discount and sold at a premium, using the straight-line amortization method

12.2.5: Discuss the effective interest rate method of amortizing bond premium and discount

Describe Various Types of Bonds

Different types of bonds:

- Straight bonds
- Zero Coupon bonds
- Convertible bonds
- Callable bonds
- Puttable bonds
- Serial bonds



Record the Entries Associated with a Bond Issue Sold at Face Value

Bonds: When a company issues bonds, it incurs a long-term liability on which periodic interest payments must be made, usually twice a year. If interest dates fall on other than balance sheet dates, the company must accrue interest in the proper periods. The following examples illustrate the accounting for bonds issued at face value on an interest date and issued at face value between interest dates.

JOURNAL				
Date	Description	Post. Ref.	Debit	Credit
Dec 31	Cash		100,000	
	Bonds Payable			100,000
	To record bonds issued at face value.			

Record the Entries Associated with a Bond Issue Sold at Face Value

Companies do not always issue bonds on the date they start to bear interest. Regardless of when the bonds are physically issued, interest starts to accrue from the most recent interest date. Firms report bonds to be selling at a stated price “plus accrued interest.” The issuer must pay holders of the bonds a full six months’ interest at each interest date. Thus, investors purchasing bonds after the bonds begin to accrue interest must pay the seller for the unearned interest accrued since the preceding interest date. The bondholders are reimbursed for this accrued interest when they receive their first six months’ interest check.

JOURNAL				
Date	Description	Post. Ref.	Debit	Credit
May 31	Cash		105,000	
	Bonds payable			100,000
	Bond interest payable ($\$100,000 \times 12\% \times (5/12)$)			5,000
	To record bonds issued at face value plus accrued interest.			

Determine the Items That Impact the Selling Price of a Bond

Bond Interest Rates

Stated interest rate

- ▶ Determines amount of cash interest borrower pays each year
- ▶ Remains constant (printed on bond)

Market interest rate

- ▶ Rate investors demand for loaning money
- ▶ Varies daily

Stated interest rate		Market interest rate		Issue price of bonds payable
9%	=	9%	→	Maturity value (\$1,000 per bond)
9%	<	10%	→	Discount (below maturity value)
9%	>	8%	→	Premium (above maturity value)

Record the Entries for a Bond Issue Sold at a Discount and Sold at a Premium Using the Straight-Line Amortization Method

Discounted Bond: When a bond is issued at a discount (less than it is worth), always record Bond Payable at the amount it has to be paid back. This is the face value or principal amount of the bond.

Difference between the price it was sold and the amount to pay back is recorded in a contra-liability account called Discount on Bonds Payable.

Discount will be removed over the life of the bond by amortizing it over the life of the bond and will increase bond interest expense when recording the semiannual interest payment.

Accounting for Bonds Issued at a Discount

- ▶ Issued \$100,000 of 8%, 10-year bonds @ 98 (price)

GENERAL JOURNAL			
DATE	DESCRIPTION	DEBIT	CREDIT
	Cash		(\$100,000 x
	<i>Issued \$100,000 of 10-yr, 8% bond</i>		

Discuss the Effective Interest Rate Method of Amortizing Bond Premium and Discount

Effective interest method. The preferable approach to recording amortization is the effective interest method that uses a constant percentage of the carrying value, rather than an equal dollar amount each year, similar to the double-declining balance method of depreciation or fixed assets.

Amortization amount. The difference between the cash paid for interest and the calculated amount of bond interest expense, and at the end of the bond carrying period, the unamortized discount or premium would be zero.



Practice Question 1

The GenZ company issues 6% bonds when the market rate is 8% and investors expect the market rate must be issued at a _____ in order to attract investors to purchase its bonds.

- A. face value
- B. premium
- C. par value
- D. discount

Leases

Learning Outcomes: Leases

12.3: Understand accounting for leases

12.3.1: Distinguish between a finance lease and an operating lease.

12.3.2: Record entries associated with leases

Distinguish Between a Finance Lease and an Operating Lease

ASU 2016-02, which was effective for publicly traded companies after Dec. 15, 2018, states that all leases, whether classified as operating or capital leases (called “finance leases” under the new standard), create a right-of-use asset and a liability that should appear on the lessee’s balance sheet.

In general terms:

- A capital lease or financing lease is one where the lessee records the leased asset as if he or she purchased the leased asset using funding provided by the lessor.
- An operating lease functions much like a traditional lease, where the lessee pays to use an asset but doesn’t enjoy any of the ownership economic benefits nor incur any of the risks that come with ownership.

Record Entries Associated with Leases

Finance Lease:

For a finance lease, the lessee debits the fixed asset account by the present value of the minimum lease payments. The credit to lease liability account is the difference between the value of the equipment and cash paid at the beginning of the year. The lessee records depreciation expense on the asset just like any other purchased asset, and the lease liability account is treated just like a note payable with a declining balance.

Operating Lease with Right-of-Use Asset:

The calculations may seem complicated at first, but in essence, it is a simple two-step process:

1. Determine the present value of the lease payments
2. Determine the direct payments that are part of the right-to-use asset

Record Entries Associated with Leases

JOURNAL				
Date	Description	Post. Ref.	Debit	Credit
	Right-of-use asset		\$18,943.60	
	Lease liability			\$17,943.60
	Checking account			\$1,000.00

Reporting Long-Term Liabilities

Learning Outcomes: Reporting Long-Term Liabilities

12.4: Illustrate proper reporting of non-current liabilities

12.4.1: Report noncurrent liabilities on the balance sheet

12.4.2: Identify common disclosures related to noncurrent liabilities

Report Noncurrent Liabilities on the Balance Sheet

Current liabilities

Loans and notes payable (Note 6)	\$3,732
Accounts payable	7,503
Accrued liabilities	5,531
Accrued rebates, returns, and promotions	2,237
Accrued salaries, wages, and commissions	1,432
Accrued taxes on income	<u>417</u>

Total current liabilities	20,852
Long-term debt (Note 6)	8,120
Deferred taxes on income (Note 8)	1,432
Employee-related obligations (Notes 5 and 13)	7,791
Other liabilities	<u>4,206</u>
	<u><u>\$42,401</u></u>

Identify Common Disclosures Related To Noncurrent Liabilities

From the AICPA Financial Reporting Framework for Small- and Medium-Sized Entities Presentation and Disclosure Checklist:

Long-Term Debt Disclosure

1. For bonds, debentures, and similar securities, mortgages, and other long-term debt, has the entity disclosed
2. The title or description of the liability?
3. The interest rate?
4. The maturity date?
5. Significant terms (for example, covenant details)?
6. The amount outstanding, separated between principal and accrued interest?
7. The currency in which the debt is payable if it is not repayable in the currency in which the entity measures items in its financial statements?
8. The repayment terms, including the existence of sinking fund, redemption, and conversion provisions? [6.15]
9. Has the entity disclosed the carrying amount of any financial liabilities that are secured? [6.16]
10. Has the entity disclosed
11. The carrying amount of assets it has pledged as collateral for liabilities?
12. The terms and conditions relating to its pledge? [6.16]

Identify Common Disclosures Related To Noncurrent Liabilities

Long-Term Debt Disclosure

1. Has the entity disclosed the aggregate amount of payments estimated to be required in each of the next five years to meet repayment, sinking fund, or retirement provisions of financial liabilities? [6.17]
2. For financial liabilities recognized at the statement of financial position date, has the entity disclosed
3. Whether any financial liabilities were in default or in breach of any term or covenant during the period that would permit a lender to demand accelerated repayment?
4. Whether the default was remedied, or the terms of the liability were renegotiated, before the financial statements were available to be issued? [6.18]
5. [sic] The maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee before any amounts that may possibly be recovered under recourse or collateralization provisions in the guarantee (see items d–e that follow)? (When the terms of the guarantee provide for no limitation to the maximum potential future payments under the guarantee, that fact should be disclosed. When the guarantor is unable to develop an estimate of the maximum potential amount of future payments under its guarantee, the guarantor should disclose that it cannot make such an estimate.)
6. The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee, regardless of whether the guarantee is freestanding or embedded in another contract?
7. The nature of any recourse provisions that enable the guarantor to recover from third parties any of the amounts paid under the guarantee?
8. The nature of any assets held as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all, or a portion of, the amounts paid under the guarantee? [17.39]
9. Has the entity disclosed the following items:
10. Interest capitalized?

Identify Common Disclosures Related To Noncurrent Liabilities

Long-Term Debt Disclosure

1. Unused letters of credit?
2. Long-term debt agreements subject to subjective acceleration clauses, unless the likelihood of the acceleration of the due date is remote? [6.19]
3. For an entity that issues any of the following financial liabilities or equity instruments, has the entity disclosed information to enable users of the financial statements to understand the effects of features of the instrument, as follows:
4. For a financial liability that contains both a liability and an equity element, the following information about the equity element including, when relevant:
5. The exercise date or dates of the conversion option?
6. The maturity or expiry date of the option?

As you can see, debt and other liabilities continue to be an area of concern for financial analysts and therefore for the FASB and the accounting profession. Much of the fraud that went on with WorldCom and Enron centered around off-balance sheet financing and other undisclosed liabilities and falsified sources of cash and other funding.

Practice Question 2

Unified, Inc. has a note payable for \$200,000 with annual payments of \$40,000. How would you as the company's accountant, report this on the Balance Sheet for the third year of the note payable term?

- A. As a current liability of \$40,000 and a long-term liability of \$80,000.
- B. As a current liability of \$20,000 and a long-term liability of \$140,000.
- C. As a current liability of \$120,000 and a long-term liability of \$80,000.
- D. As a long-term liability of \$200,000.

Quick Review

- How are alternatives for financing on a long-term basis evaluated?
- How are journal entries related to notes payable recorded?
- What are the implications of the time value of money?
- What are the various types of bonds?
- How are the entries associated with a bond issue sold at face value recorded?
- What items impact the selling price of a bond?
- How are the entries for a bond issue sold at a discount and sold at a premium, using the straight-line amortization method recorded?
- What is the effective interest rate method of amortizing bond premium and discount?
- What is the difference between a finance lease and an operating lease?
- How are entries associated with leases recorded?
- How are noncurrent liabilities reported on the balance sheet?
- What common disclosures are related to noncurrent liabilities?