Chapter 14: Long Term Liabilities

I. Characteristics of a long-term liability

- A. See FASB definition of a liability
- B. Repayment of principal extends beyond 1 year or the operating cycle
- C. Considerable formality associated with long-term debt issuances
  - -- bond indenture: enforceable contract
  - -- covenants/restrictions: protection for investor

II. Bonds

- A. Valuation
  - 1) Present value (PV) of two cash flow streams (the series of interest payments and the principal payment) discounted at the market or effective rate of interest.
  - 2) The market and stated interest rates are not usually the same.
    - -- this difference causes the price of the bond to vary from the face value of the bond.
    - -- actual cash interest paid/received is determined by multiplying the face/stated amount of the bonds and the stated rate of interest
    - -- the effective rate of interest is the true rate of interest incurred by the issuer and earned by the investor after taking the price of the bond into account (interest expense = effective rate * carrying value).
  - 3) Bonds issued at par:
    - -- stated rate = market rate
    - -- price of bond = face value of bond
    - -- interest expense/revenue = cash paid/received
  - 4) Bonds issued at a discount:
    - -- stated rate < market rate
    - -- price of bond < face value of bond
    - -- amortization of discount effectively increases interest expense
  - 5) Bonds issued at a premium:
    - -- price of bond > face value of bond
    - -- stated rate > market rate
    - -- amortization of premium effectively decreases interest expense
- B. Amortization of Discounts/Premiums
  - 1) Use the effective interest method – the straight-line method may be used when the results are not materially different from the effective interest rate method.
  - 2) Effective interest rate method results in interest expense that is a constant percentage of the carrying value of the bonds – thus interest expense varies from period to period. In contrast, the straight-line method results in a constant interest expense from period to period.
  - 3) Understand the differences between the two methods and how to prepare amortization tables for each method.

C. Other Issues

1) Bonds issued between interest payment dates

-- Buyers pay the seller the interest accrued from the last interest payment date to the issue date.

-- Seller records this as a credit to interest expense and then pays the buyer the full amount of interest at the next interest payment date.

2) If the interest payment date and the financial statement date are not the same, interest must be accrued and the discount or premium amortized for the appropriate time period.

3) Bond issue costs are accounted for as a deferred charge and are amortized over the life of the bonds.

D. Extinguishment of Debt

1) Bonds may be held to maturity and paid according to the original terms

2) Early extinguishment of debt:

-- a extraordinary gain or loss will exist computed as the difference between the reacquisition price and the carrying value of the bonds (note that this carrying value is adjusted for any unamortized bond premium/discount and bond issue costs).

-- debt can be extinguished by either paying the debt off early (direct payment to the creditor) or by purchasing the bonds in the open market. In either case, you need to amortize the premium/discount up to the reacquisition date, accrue interest up to the reacquisition date, remove bonds and related accounted and recognize the gain/loss.

III. Notes

A. Accounting for bonds and notes is similar.

B. Notes can be either interest bearing, non-interest bearing. In either case, the note is valued at the PV of its cash flow streams discounted at the effective interest rate.

C. If the note bears an unrealistic interest rate, you must value the note using an imputed interest rate.

D. Note issued for property, goods, etc.

1) The difference between the face amount of the note and the fair value of the property is interest.

2) If there is an unrealistic stated rate also, the above difference plus the interest computed with the stated rate go into the determination of interest expense.

E. Note issued for cash plus other rights and priviliges

1) Recognize the note and cash received.

2) Also recognize a discount and unearned revenue equal to the difference between the PV of the note and the amount of cash received.

III. Troubled Debt (Appendix)

A. Issues

1) Recognition – creditor will recognize the "loss" when it is probable and reasonably estimable the loss will occur. Debtor will not recognize a

"gain" until some settlement or modification of loan terms exist.

2) Measurement of gain/loss – various methods are possible: in general, compare the pre-restructuring carrying value of the debt to the future cash flows (either undiscounted, discounted at the market rate of interest at time of restructuring or discounted at the historical effective interest rate).

B. Impairment

1) Creditor: A loan is impaired when it's probable the creditor will be unable to collect all amounts due according to the debt agreement. The impairment loss is measured as the difference between the investment in the loan (typically the carrying value) and the future cash flows discounted at the historical effective interest rate.

2) Debtor: does nothing

C. Restructuring of the Note

1) Settlement of Debt

a) Transfer noncash assets

-- creditor: recognizes a "loss" equal to the carrying value of the receivable less the fair market value of the assets.

-- debtor: recognizes an extraordinary gain based on the difference between the fair value of the asset and the carrying value of the debt; recognizes an ordinary gain based on the difference between the book value of the asset and the fair value of the asset.

b) Grant an equity interest

-- creditor: recognizes a "loss" equal to the carrying value of the receivable less the fair market value of the equity interest granted.

-- debtor: recognizes an extraordinary gain based on the difference between the carrying value of the debt and the fair value of the equity granted.

2) Modification of Terms

a) Creditors loss is measured as the difference between the pre-restructuring carrying value of the debt and the present value of the restructured cash flows.

b) Debtor:

-- No Gain Situation: If the undiscounted restructured future cash flows are greater than the pre-restructuring carrying value of the debt there is no gain; debtor does nothing initially but must compute a new effective interest rate to record future interest expense.

-- Gain Situation: Occurs when the undiscounted restructured future cash flows are less than the pre-restructuring carrying value of the debt; recognize the gain and implicit interest for future periods is zero.