Chapter 10

Reporting and Analyzing Liabilities

Study Objectives

1. Explain a current liability and identify the major types of current liabilities.
2. Describe the accounting for notes payable.
3. Explain the accounting for other current liabilities.
4. Identify the types of bonds.
5. Prepare the entries for the issuance of bonds and interest expense.
6. Describe the entries when bonds are redeemed.
7. Identify the requirements for the financial statement presentation and analysis of liabilities.
8. Apply the straight-line method of amortizing bond discount and bond premium.
9. Apply the effective-interest method of amortizing bond discount and bond premium.
10. Describe the accounting for long-term notes payable.

Current Liabilities

Current liability:
1. Company expects to pay the debt from existing current assets or through the creation of other current liabilities.
2. Company will pay the debt within one year or the operating cycle, whichever is longer.

Current liabilities include notes payable, accounts payable, unearned revenues, and accrued liabilities such as taxes, salaries and wages, interest payable, etc.

Question

To be classified as a current liability, a debt must be expected to be paid:
- out of existing current assets.
- by creating other current liabilities.
- within 2 years.
- both (a) and (b).

Notes Payable

- Written promissory note.
- Interest.
- Current liability if due within one year of the balance sheet date.

Illustration: First National Bank agrees to lend $100,000 on September 1, 2010, if Cole Williams Co. signs a $100,000, 12%, four-month note maturing on January 1.

Sept. 1

Illustration: If Cole Williams Co. prepares financial statements annually, it makes an adjusting entry at December 31 to recognize interest.

Dec. 31

* $100,000 x 12% x 4/12 = 4,000

Illustration: At maturity (January 1), Cole Williams Co. must pay the face value of the note plus interest. It records payment as follows.

Jan. 1
Current Liabilities

Sales Tax Payable
- Sales taxes are a percentage of the sales price.
- Retailer collects tax from the customer.
- Retailer remits the collections to the state's department of revenue.

Illustration: March 25, cash register readings for Cooley Grocery show sales of $10,000 and sales taxes of $600 (sales tax rate of 6%), the journal entry is:

Mar. 25

Current Liabilities

Unearned Revenue
Revenues that are received before the company delivers goods or provides services.
1. Company debits Cash, and credits a current liability account (unearned revenue).
2. When the company earns the revenue, it debits the Unearned Revenue account, and credits a revenue account.

Illustration: Superior University sells 10,000 season football tickets at $50 each for its five-game home schedule. The entry for the sales of season tickets is:

After the first game, Superior records the earning of revenue with the following entry.

Current Liabilities

Payroll and Payroll Taxes Payable
The term "payroll" pertains to both:
- Salaries - managerial, administrative, and sales personnel (monthly or yearly rate).
- Wages - store clerks, factory employees, and manual laborers (rate per hour).

Determining the payroll involves computing three amounts: (1) gross earnings, (2) payroll deductions, and (3) net pay.

Illustration: Assume Cargo Corporation records its payroll for the week of March 7 as follows:

Mar. 7 Salaries and wages expense 100,000
FICA tax payable 7,650
Federal tax payable 21,864
State tax payable 2,922
Salaries and wages payable 67,564

Record the payment of this payroll on March 7.

Mar. 7

Current Liabilities

Current Maturities of Long-Term Debt
- Portion of long-term debt that comes due in the current year.

Illustration: Wendy Construction issues a five-year, interest-bearing $25,000 note on January 1, 2009. This note specifies that each January 1, starting January 1, 2010, Wendy should pay $5,000 of the note. When the company prepares financial statements on December 31, 2009,

1. What amount should be reported as a current liability? _________
2. What amount should be reported as a long-term liability? _______

Current Liabilities

Payroll tax expense results from three taxes that governmental agencies levy on employers.

These taxes are:
- FICA tax
- Federal unemployment tax
- State unemployment tax
Illustration: Based on Cargo Corp.'s $100,000 payroll, the company would record the employer's expense and liability for these payroll taxes as follows.

- Payroll tax expense: $13,850
- FICA tax payable: $7,650
- State unemployment tax payable: $800
- Federal unemployment tax payable: $5,400

**Question**

Employer payroll taxes do not include:
- Federal unemployment taxes.
- State unemployment taxes.
- Federal income taxes.
- FICA taxes.

**Current Liabilities**

**Bond: Long-Term Liabilities**

**Types of Bonds**
- Secured
- Unsecured
- Convertible
- Callable

**Issuing Procedures**

- Bond certificate
  - Issued to the investor.
  - Provides information such as the
    - Name of the company issuing bonds,
    - Face value,
    - Maturity date, and
    - Contractual interest rate (stated rate).

**Determining the Market Value of Bonds**

Three factors that determine present value:
1. Dollar amounts to be received,
2. Length of time until the amounts are received, and
3. Market rate of interest.

**Accounting for Bond Issues**

A corporation records bond transactions when it
- Issues or retires (buys back) bonds and
- When bondholders convert bonds into common stock.

Bonds may be issued at
- Face value,
- Below face value (discount), or
- Above face value (premium).

Bond prices are quoted as a percentage of face value.
The rate of interest investors demand for loaning funds to a corporation is the:

a. contractual interest rate.
b. face value rate.
c. market interest rate.
d. stated interest rate.

**Question**

Prepare the entries for the issuance of bonds and interest expense.

**Issuing Bonds at Face Value**

Prepare the entry Devor would make to pay the interest on Jan. 1, 2011.

**Accounting for Bond Issues**

Assume Contractual Rate of 10%

Market Interest

- 8%
- 10%
- 12%

Bonds Sold At

**Question**

Karson Inc. issues 10-year bonds with a maturity value of $200,000. If the bonds are issued at a premium, this indicates that:

a. the contractual interest rate exceeds the market interest rate.
b. the market interest rate exceeds the contractual interest rate.
c. the contractual interest rate and the market interest rate are the same.
d. no relationship exists between the two rates.

**Issuing Bonds at a Discount**

Discount on Bonds Payable:

- has a credit balance.
- is a contra account.
- is added to bonds payable on the balance sheet.
- increases over the term of the bonds.
Illustration: Assume that the Candlestick Inc. bonds previously described sell at 102 rather than at 98. The entry to record the sale is:

\[
\text{Issuing Bonds at a Premium}
\]

Statement Presentation

CANDLESTICK INC.
Balance Sheet (partial)

<table>
<thead>
<tr>
<th>Long-term liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds payable</td>
<td>$100,000</td>
</tr>
<tr>
<td>Add: Premium on bonds payable</td>
<td>$2,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$102,000</strong></td>
</tr>
</tbody>
</table>

Redeeming Bonds at Maturity

Candlestick records the redemption of its bonds at maturity as follows:

Accounting for Bond Retirements

Redeeming Bonds before Maturity

1. eliminate the carrying value of the bonds;
2. record the cash paid; and
3. recognize the gain or loss on redemption.

The carrying value of the bonds is the face value of the bonds less unamortized bond discount or plus unamortized bond premium at the redemption date.

Accounting for Bond Retirements

Question

When bonds are redeemed before maturity, the gain or loss on redemption is the difference between the cash paid and the:

a. carrying value of the bonds.
b. face value of the bonds.
c. original selling price of the bonds.
d. maturity value of the bonds.

Balance Sheet Presentation

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Notes payable</td>
<td>$99,680</td>
<td>$95,375</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>176,118</td>
<td>153,260</td>
</tr>
<tr>
<td>Current maturities of long-term debt</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>75,000</td>
<td>75,000</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td>$375,041</td>
<td>$344,937</td>
</tr>
<tr>
<td>Long-term liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds payable</td>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Less: Discount on bonds payable</td>
<td>80,000</td>
<td>92,000</td>
</tr>
<tr>
<td>Notes payable, secured by plant assets</td>
<td>540,000</td>
<td>540,000</td>
</tr>
<tr>
<td>Lease liability</td>
<td>600,000</td>
<td>600,000</td>
</tr>
<tr>
<td><strong>Total long-term liabilities</strong></td>
<td>$3,710,000</td>
<td>$3,710,000</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>$3,710,000</td>
<td>$3,710,000</td>
</tr>
</tbody>
</table>

Financial Statement Analysis and Presentation

Analysis

<table>
<thead>
<tr>
<th>TOYOTA MOTOR CORPORATION</th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>$ 99,680</td>
<td>$ 95,375</td>
</tr>
<tr>
<td>Noncurrent liabilities</td>
<td>176,118</td>
<td>153,260</td>
</tr>
<tr>
<td>Total assets</td>
<td>$375,041</td>
<td>$344,937</td>
</tr>
<tr>
<td>Liabilities and Stockholders' Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>$ 99,680</td>
<td>$ 95,375</td>
</tr>
<tr>
<td>Noncurrent liabilities</td>
<td>75,986</td>
<td>69,315</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>175,676</td>
<td>164,684</td>
</tr>
<tr>
<td>Total stockholders' equity</td>
<td>108,263</td>
<td>89,899</td>
</tr>
<tr>
<td>Total liabilities and stockholders' equity</td>
<td>$275,041</td>
<td>$254,582</td>
</tr>
</tbody>
</table>
Chapter 10-46

**Effective-Interest Amortization**

### Required steps:

1. Compute the bond interest expense.
2. Compute the bond interest paid or accrued.
3. Compute the amortization amount.

### Illustration 10B-1

**Effective-Interest Amortization**

#### Bond Interest Expense

<table>
<thead>
<tr>
<th>Carrying Value at Beginning of Period</th>
<th>Effective Interest Rate</th>
<th>Bond Interest Expense</th>
<th>Amortization Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>10.53%</td>
<td>$10,530</td>
<td>$10,530</td>
</tr>
<tr>
<td>$100,000</td>
<td>10.53%</td>
<td>$10,530</td>
<td>$10,530</td>
</tr>
<tr>
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<td>$10,530</td>
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</tr>
<tr>
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<td>10.53%</td>
<td>$10,530</td>
<td>$10,530</td>
</tr>
</tbody>
</table>

### Illustration 10B-2

**Candlestick, Inc.** sold $100,000, five-year, 10% bonds on January 1, 2010, for $98,000. The effective-interest rate is 10.53% and interest is payable on Jan. 1 of each year. Prepare the bond discount amortization schedule.

### Illustration 10B-3

Candlestick, Inc. records the accrual of interest and amortization of bond discount on Dec. 31, as follows:

Dec. 31

### Illustration 10B-4

Candlestick, Inc., sold $100,000, five-year, 10% bonds on January 1, 2010, for $102,000. The effective-interest rate is 9.48% and interest is payable on Jan. 1 of each year. Prepare the bond premium amortization schedule.

### Long-Term Notes Payable

#### Illustration 10C-1

Porter Technology Inc. issues a $500,000, 12%, 20-year mortgage note on December 31, 2010. The terms provide for semiannual installment payments of $33,231.

### Long-Term Notes Payable

May be secured by a mortgage that pledges title to specific assets as security for a loan.

Typically requires installment payments over the term of the loan. Payment consists of:

1. Interest on the unpaid balance and
2. a reduction of loan principal.

Companies initially record mortgage notes payable at face value.

### Long-Term Notes Payable

#### Illustration 10C-2

Porter Technology Inc. issues a $500,000, 12%, 20-year mortgage note on December 31, 2010. The terms provide for semiannual installment payments of $33,231.
Illustration: Porter Technology records the mortgage loan and first installment payment as follows:

Dec. 31

Jun. 30

Question
Each payment on a mortgage note payable consists of:

a. interest on the original balance of the loan.

b. reduction of loan principal only.

c. interest on the original balance of the loan and reduction of loan principal.

d. interest on the unpaid balance of the loan and reduction of loan principal.