Dutchess Community College

ACC 104 – Financial Accounting

Quiz Prep Chapter 10

Reporting & Analyzing Liabilities

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Disclaimer

This *Quiz Prep* is provided as an outline of the key concepts from the chapter.

It is not intended to be comprehensive or exhaustive.

Quizzes may include material from the classroom lectures, the text or the homework assignments.

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Liabilities

Two categories of liabilities:

- Current
- Long Term

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Current Liabilities

Debts that are payable within one year or the operating cycle, whichever is longer:

- Accounts Payable
- Notes Payable (within 1 year)
- Unearned Revenue
- Accrued Liabilities
- Current Maturities of Long-Term Debt

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Accounts Payable

Amounts owed for trade purchases such as supplies and inventory.

Typically are payable within 30 days.

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Notes Payable

Amounts borrowed for periods up to 1 year.

May be related to trade purchases (such as for inventory) but is distinguished from *Accounts Payable* by:

- legal document (the *Note*) signed by the borrower (you)
- an interest rate is expressly stated

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Notes Payable

The journal entries are the inverse of those for *Notes Receivable* from chapter 8.

On January 1 you borrowed $100,000 for one year at 12% per year paid semi-annually.

	Dr	Cr
Cash	100,000	
Notes Payable		100,000

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Notes Payable

On March 31, you must accrue
$100,000 x 12% / 12 x 3 = $3,000 Interest Expense.

Adjusting Entry:

	Dr	Cr
Interest Expense	3,000	
Interest Payable		3,000

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Notes Payable

When you pay 6 months of interest on June 30 the entry would be:

	Dr	Cr
Interest Payable	3,000	
Interest Expense	3,000	
Cash		6,000

This reverses the accrual made on March 31

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Unearned Revenue

Unearned Revenue arises when you have been paid to provide a service that you have not yet provided; e.g., you have been paid $10,000 to paint a house but have not yet begun.

Unearned Revenue is a Liability, typically current, because you either must provide the service or return the money.

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Unearned Revenue

Example: An ice skating rink sells 100 books of admission tickets for $50 each ($5,000 total). Each book has 10 tickets (1,000 total @ $5 each)

	Dr	Cr
Cash	5,000	
Unearned Revenue		5,000

At the end of the accounting period, 200 tickets have been used.

	Dr	Cr
Unearned Revenue	1,000	
Revenue		1,000

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Accrued Liabilities

In addition to all the accrued liabilities covered in Chapter 4 and the Accrued Interest Payable already mentioned, Chapter 10 introduces

- Sales Tax Payable
- Payroll & Payroll Taxes Payable

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Sales Tax Payable

Sales taxes in your area are 8%.

If you sell $100 of merchandise you will collect $8 tax which you must remit to the government.

	Dr	Cr
Cash	108	
Sales Revenue		100
Sales Tax Payable		8

NOTE that the Sales Tax you collect is NOT revenue.

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Payroll & Payroll Taxes Payable

Your employees earn $100,000 from which a variety of taxes must be collected.

	Dr	Cr
Salary Expense	100,000	
FICA Tax Payable (Social Security)		6,200
Medicare Tax Payable		1,450
Federal Tax Payable		22,000
State Tax payable		5,000
Salaries Payable		65,350

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Payroll & Payroll Taxes Payable

Note that FICA and Medicare Taxes are paid 50% by the employee and 50% by the Employer.

Additionally, Employers must pay Unemployment Taxes and the cost for any company provided benefits.

	Dr	Cr
Salary Expense	13,450	
FICA Tax Payable		6,200
Medicare Tax Payable		1,450
Federal Unemployment Tax Payable		800
State Unemployment Tax payable		5,000

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	Dr	Cr
Salary Expense	13,450	
FICA Tax Payable		6,200
Medicare Tax Payable		1,450
Federal Unemployment Tax Payable		800
State Unemployment Tax payable		5,000

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Long Term Debt

Debts that are payable in more than one year, typically in the form of a Bond.

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Long Term Debt

The long-term portion should be shown net of any current portion.

Example:
A company borrows $100,000 to be repaid $10,000 per year for 10 years.

Current Liabilities:	
Current Maturities of LT Debt	$ 10,000
Long Term Debt	$ 90,000

NOTE that LT Debt is NET of current portion

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Bonds

Characteristics:

- **Company Name**
- **Par** or **Face Value** or **Principal**: the amount to be repaid at maturity, usually multiples of $1,000
- **Maturity Date**: date at which you will receive the Par or Face Value or the Principal.
- **Coupon** or **Contractual Interest Rate:** the amount of interest paid by the borrower, quoted on an annual basis and usually paid on a semi-annual basis.

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Bonds

Types of Bonds:

- **Secured**: specific assets, such as a building or inventory, are pledged as collateral. The bond holder can file a claim against the assets pledged if the company fails to make payments on the bond.
- **Unsecured**: The bond is NOT backed by specific assets. It is backed by the "good faith and credit" of the borrower. Unsecured Bonds are also known as *Debentures*.

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Bonds

Types of Bonds:

• **Callable**: the bond can be *called* back, i.e., paid-off earlier than the stated maturity date, usually at a premium, i.e., a price higher than par value. The decision to pay off the bond earlier is made by the borrower.

• **Convertible**: the bond can be traded in for a set number of shares of stock. The decision to trade in the bond for stock is made by the lender.

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Bonds

Pricing Convention: Bond prices are quoted in terms of 100, as in 100%; i.e., a bond with a Par amount of $1,000 selling for 99.5 would cost $995.

Market Rate of Interest or **Yield**: The current interest rate that bonds issued by a similar company would earn.

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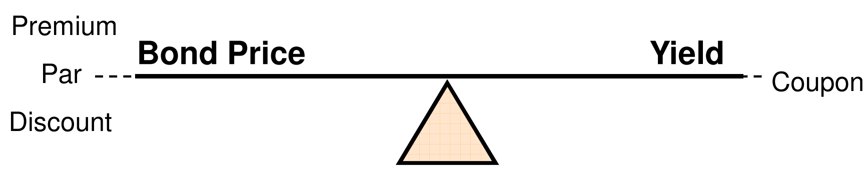
Bonds

Par Bond: Price = Par (100); Yield = Coupon



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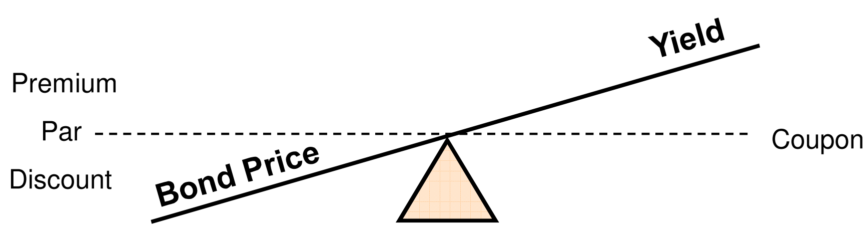
Bonds

Par Bond: Price = Par (100); Coupon = Yield

Discount Bond: Price < Par; Yield > Coupon



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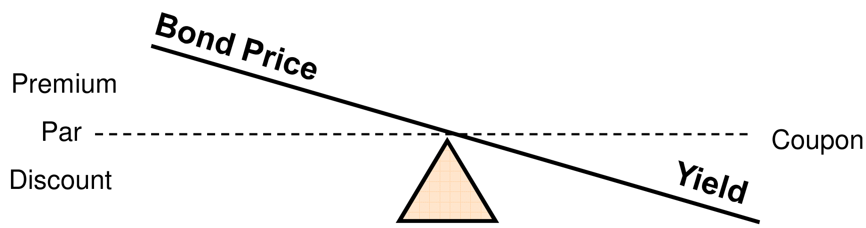
Bonds

Premium Bond: Price > Par (100); Yield < Coupon

Par Bond: Price = Par (100); Yield = Coupon

Discount Bond: Price < Par; Yield > Coupon



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Debt to Total Assets Ratio

$$\text{Debt to Total Assets Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

The **Debt to Total Assets Ratio** tells you the percentage of the firm's assets that was financed by borrowing.

Unlike equity, debt has to be repaid at specified times, therefore

Lower is Better

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Times Interest Earned (TIE) Ratio

$$\text{TIE Ratio} = \frac{\text{Net Income + Interest Expense + Tax Expense}}{\text{Interest Expense}}$$

The **Times Interest Earned Ratio** gives you an indication of a company's ability to meet interest payments.

Higher is Better

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