CHAPTER 14

LONG-TERM FINANCIAL LIABILITIES

CHAPTER TOPICS CROSS REFERENCED WITH *CICA HANDBOOK*, PART I (IFRS) AND PART II (ASPE)

Long-term debt currently maturing	IAS 32	Section 1510
Financial Instruments—recognition and measurement	IFRS 9 (previously IAS 39)	Section 3856
Financial Instruments—presentation	IFRS 9 and IAS 32	Section 1521
Financial Instruments—disclosure	IFRS 7	Section 3856

LEARNING OBJECTIVES

1. Understand the nature of long-term debt financing arrangements.

2. Understand how long-term debt is measured and accounted for.

3. Understand when long-term debt is recognized and derecognized, including how to account for troubled debt restructurings.

4. Explain how long-term debt is presented on the statement of financial position.

5. Identify disclosure requirements.

6. Calculate and interpret key ratios related to solvency and liquidity.

7. Identify major differences in accounting between IFRS and ASPE, and what changes are expected in the near future.

CHAPTER REVIEW

1. Chapter 14 presents a discussion of the issues related to long-term financial liabilities. Long-term debt consists of probable future sacrifices of economic benefits. These benefits are payable in the future, normally beyond one year or operating cycle, whichever is longer. Coverage in this chapter includes bonds payable, long-term notes payable, mortgage notes payable, issues related to the extinguishment of debt, the fair value option and issues surrounding off-balance sheet financing. The accounting and disclosure issues related to long-term liabilities includes a great deal of detail due to the potentially complicated nature of debt instruments.

Nature of Long-term debt

1. Long-term debt consists of obligations of an entity arising from past transactions or events that are not payable within the next year or operating cycle, whichever is longer. These obligations normally require a **formal agreement** between the parties involved that often includes certain **covenants and restrictions** for the protection of both lenders and borrowers. These covenants and restrictions are found in the **bond indenture** or **note agreement**, and include information related to amounts authorized to be issued, interest rates, due dates, call provisions, security for the debt, sinking fund requirements, etc. The important issues related to long-term debt should always be disclosed in the financial statements or the notes thereto.

2. Long-term liabilities include **bonds payable, mortgage notes payable, long-term notes payable, lease obligations**, and **pension obligations**.

Bonds Payable

1. **Bonds payable** represent an obligation of the issuing corporation to pay a sum of money at a designated maturity date plus periodic interest at a specified rate on the face value. The following terms are commonly used in discussing the various aspects of corporate bond issues.

   a. **Bond Indenture**. Describes the contractual agreement between the corporation issuing the bonds and the bondholders.

   b. **Face Value**. Amount stated on the face of the bond which serves as the basis for periodic interest computations, and represents the amount due at maturity (also known as **maturity value** or **par value**).

c. **Term Bonds**. Issues that mature on a single date.

d. **Serial Bonds**. Issues that mature in periodic instalments.

e. **Mortgage Bonds**. Secured bonds having a claim on real estate.

f. **Junk Bonds**. Term used to describe bonds that are unsecured and pay a high rate of interest because of the high risk associated with the bonds.

g. **Debenture Bonds**. Unsecured bonds.

h. **Convertible Bonds**. Bonds that may be exchanged for other securities of the corporation.

i. **Commodity-Backed Bonds**. Bonds that are redeemable in measures of a commodity such as barrels of oil, bushels of wheat, or ounces of a rare metal (also called **asset-linked bonds**).

j. **Deep Discount Bonds**. Bonds sold at a discount that provides the buyer's total interest payoff at maturity (in Canada, **zero-coupon bonds**, or **stripped bonds**, are a form of deep-discount bond).

k. **Income Bonds**. Interest payments depend on the existence of operating income. **Revenue bonds** are bonds on which the interest is paid from specified revenue sources.

l. **Callable Bonds**. Issuer reserves the right to call and retire the bonds prior to maturity.

m. **Registered Bonds**. Bonds issued in the name of the owner.

n. **Bearer or Coupon Bonds**. Bonds not recorded in the name of the owner, transferred by mere delivery.

2. **Bonds** are debt instruments of the issuing corporation used by that corporation to borrow funds from the general public or institutional investors. The use of bonds provides the issuer an opportunity to divide a large amount of long-term indebtedness among many small investing units. Bonds may be sold through an **underwriter** who either (a) guarantees a certain sum to the corporation and assumes the risk of sale, or (b) agrees to sell the bond issue on the basis of a commission. Alternatively, a corporation may sell the bonds directly to a large financial institution without the aid of an underwriter.

3. If an entire bond issue is not sold at one time, both the amount of the **bonds authorized** and the **bonds issued** should be disclosed on the balance sheet or in a note. This discloses the potential indebtedness represented by the unissued bonds.

4. Bonds are issued with a **stated (coupon or nominal) rate** of interest expressed as a percentage of the **face value** of the bonds. When bonds are sold for more than face value (at a **premium**) or less than face value (at a **discount**), the interest rate actually earned by the bondholder is different from the stated rate. This is known as the **effective yield** or **market rate** of interest and is set by economic conditions in the investment market. The effective yield exceeds the stated rate when the bonds sell at a discount, and the effective yield is less than the stated rate when the bonds sell at a premium.

5. To compute the effective interest rate of a bond issue, the present value of future cash flows from interest and principal must be computed. This often takes a financial calculator or a computer to calculate.

Discounts and Premiums

1. Premiums and discounts resulting from a bond issue are recorded at the time the bonds are sold. These items are amortized each time bond interest is paid. The time period over which discounts and premiums are amortized is equal to the period of time the bonds are outstanding (date of sale to maturity date). Amortization of bond premiums decreases the recorded amount of bond interest expense, while the amortization of bond discounts increases the recorded amount of bond interest expense.

2. When a bond sells at a **discount**, the proceeds received are less than the face value of the bond, the amount to be repaid at maturity. The difference, or discount, represents additional interest to be paid on the bond. The additional interest increases the interest rate paid on the bond above the bond's stated rate, i.e., **the effective-interest rate is greater than the stated interest rate**. This discount is allocated (amortized) to bond interest expense over the life of the bond, using the **effective-interest method**.

3. The calculation of the **discount amortization** consists of three steps: (a) calculate bond interest expense by multiplying the carrying value of the bond at the beginning of the period by the effective-interest rate; (b) calculate the bond interest paid by multiplying the face value of the bond by the stated interest rate; and (c) calculate the amortization amount by taking the difference between the bond interest expense amount and the bond interest paid amount. The amount of the discount amortization is credited to the Bonds Payable account, increasing the carrying value.

4. When a bond sells at a **premium**, the proceeds received are greater than the face value of the bond, the amount to be repaid at maturity. The difference, or premium, represents a reduction of interest to be paid on the bond. The reduced interest decreases the interest rate paid on the bond below the bond's stated rate, i.e., **the effective-interest rate is less than the stated interest rate**. This premium is allocated (amortized) to bond interest expense over the life of the bond, using the **effective-interest method**, in a manner similar to the amortization of the bond discount discussed above.

5. To illustrate the recording of bonds sold at a discount or premium the following examples are presented. If Aretha Company issued $100,000 of bonds dated January 1, 2014, at 98, on January 1, 2014, the entry would be as follows:

Cash ($100,000 x .98)	98,000	
Bonds Payable		98,000

If the same bonds noted above were sold for 102, the entry to record the issuance would be as follows:

Cash ($100,000 x 1.02)	102,000	
Bonds Payable		102,000

(Note that most of the examples in this chapter's journal entries are shown on a "net" basis, meaning that discount and premium accounts are not used. For bookkeeping purposes, either method can be used, however when receivables or payables have discounts or premiums, they must be shown on the financial statements on a net bases, regardless of the bookkeeping method used.)

6. To illustrate the amortization of the bond discount or premium, assuming a simplified **straight-line method** is used, the bonds sold in the example in paragraph 5 above are five-year bonds. Since the bonds are sold on the issue date (January 1, 2014) they will be outstanding for the full five years. Thus, the discount or premium would be amortized over the entire life of the bonds. The entry to amortize the bond discount at the end of 2014 would be:

Bond Interest Expense	400	
Bonds Payable		400

The entry to amortize the premium would be:

Bonds Payable	400	
Bond Interest Expense		400

Note that the amortization of the discount increases the bond interest expense for the period and the amortization of the premium reduces bond interest expense for the period.

7. When bonds are issued between interest dates, the issuer must receive the purchase price plus an amount equal to the interest earned on the bonds since the last interest payment date. On the next interest payment date, the bondholder receives the entire semi-annual (if payable semi-annually) interest payment. However, the amount of interest expense to the issuing corporation is the difference between the semi-annual interest payment and the amount of the interest prepaid by the purchaser. For example, assume a 10-year bond issue in the amount of $300,000 bearing 9% interest payable semi-annually is dated January 1, 2014. If the entire bond issue is sold at par on March 1, 2014, the following journal entry would be made by the seller:

Cash	304,500	
Bonds Payable		300,000
Bond Interest Expense		4,500*

*($300,000 x .09 x 1/6)

The entry for the semi-annual interest payment on July 1, 2014, would be as follows:

Bond Interest Expense	13,500	
Cash		13,500

The total bond interest expense for the six-month period is $9,000 ($13,500 – $4,500), which represents the correct interest expense for the four month period the bonds were outstanding.

8. Bond premiums and discounts may be amortized using the **straight-line method** as illustrated in paragraph 6 and this method is allowable under ASPE. However, the method required under IFRS is the **effective interest method**. This method can also be used under ASPE. It computes bond interest using the effective yield at which the bonds are issued. More specifically, interest cost for each period is the effective interest rate multiplied by the carrying value (book value) of the bonds at the start of that period. The effective interest method is best accomplished by preparing a Schedule of Bond Interest Amortization. This schedule provides the information necessary for each semi-annual entry for interest and discount or premium amortization. Spreadsheet software can be used in preparing the schedules necessary to apply the effective interest method.

9. Unamortized premiums/discounts are added/deducted from bonds payable and presented net in the liability section of the statement of financial position. If premium and discount accounts are used, the premium is added to bonds payable and the discount is deducted from bonds payable.

10. If the interest payment date does not coincide with the financial statement date, the amortized premium or discount should be prorated by the appropriate number of months to arrive at the proper interest expense.

11. Both the straight-line and effective interest method of discount/premium amortization will result in the same total amount of interest expense over the terms of the bond.

Special Situations

1. Financial liabilities should initially be recognized at fair value which is generally the exchange value that exists in an arm's length transaction.

2. Interest-bearing marketable securities are treated the same as bonds—a discount or premium is recognized if the stated rate is different than the effective yield. Zero-interest-bearing marketable securities represent a discount on the note and the discount is amortized similar to the manner on interest-bearing notes.

3. When a long-term note is issued **solely for cash**, the interest factor is assumed to be the stated or coupon rate plus or minus the amortization of the discount or premium. In **special situations** where a note is exchanged for **cash and some additional privilege**, the difference between the present value of the payable and the amount of cash loaned should be recorded as a discount on the note and as unearned revenue. This discount should be amortized by a charge to interest expense over the term of the note using the effective interest method. The unearned revenue is prorated on the same basis as the privilege that gave rise to the unearned revenue is realized by the lender/customer. For example, the privilege may be a favourable merchandise purchase agreement. In this case, the unearned revenue is prorated on the same basis that each period's sales to the lender/customer bear to the total sales to that customer for the term of the note.

4. When a debt instrument is exchanged for **non-cash consideration,** such as property, goods, or services, the stated rate of interest is presumed fair unless (a) no interest rate is stated, (b) the stated rate is unreasonable, or (c) the face amount of the debt is materially different from the current cash price of the consideration or the current market value of the debt.

5. The imputed interest rate used for valuation purposes will normally be at least equal to the rate at which the debtor can obtain financing of a similar nature from other sources at the date of the transaction. The object is to approximate the rate that would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions. If a higher rate were determined to be the market rate of interest, the land and selling price would be measured at a lower amount due to the inverse relationship between the discount rate and the present value of the cash flows. This may indicate that the cash sales price of the land has been overstated as, in general, a vendor in an arm's length transaction will want to receive an amount equal to the fair value of the land. Therefore judgment may be required to determine if the stated fair value of the asset or the imputed interest rate is more reliable.

6. **Fair Value Option**. Generally long-term debt is measured at cost, however under ASPE, the fair value option is allowed to value all financial instruments. IFRS allows the fair value option to be used to measure long-term debt only if doing so results in more relevant information. Applying the fair value option in measurement of long-term debt could be counterproductive as it requires the use of a company's own credit risk in the valuation model, which could result in recognition of a gain, even though the company is technically worse off due to the re-valuation.

Extinguishment of Debt/Derecognition

1. The extinguishment, or payment, of long-term liabilities can be a relatively straightforward process when the debt is held to maturity—no gain or loss is calculated. The process can also be a complicated one when the debt is extinguished prior to maturity. Extinguishment of debt occurs when:
    1. The debtor discharges the liability by paying the creditor
    2. The debtor is legally released from primary responsibility for the liability by law or by the creditor.

2. The reacquisition of debt can occur either by payment to the creditor or by reacquisition in the market. At the time of reacquisition, any unamortized premium or discount related to the bonds, must be amortized up to the reacquisition date. If this is not done, any resulting gain or loss on the extinguishment would be misstated. The difference between the reacquisition price and the net carrying amount of the debt is a gain or loss from extinguishment.

3. Gains or losses from debt extinguishment would be reported in the income statement. Differences between the carrying value of any new bonds issued and the old bonds redeemed is treated as a gain or loss in the current year's income statement.

4. The following terms are important to an understanding of the accounting for early extinguishment of debt securities.

    a. **Extinguishment of Debt/Derecognition**. When debt is repaid or extinguished, i.e., when an obligation is discharged, cancelled or expires, it is derecognized from the financial statements.

    b. **Reacquisition Price**. The amount paid on early extinguishment. Includes any call premium and expense of reacquisition.

    c. **Net Carrying Amount**. Amount of bonds payable at maturity, adjusted for unamortized premium or discount.

d. **Gain or Loss from Extinguishment**. Difference between reacquisition price and net carrying amount of bonds, recognized in income of the period of redemption. If reacquisition price exceeds net carrying amount, a loss results.

e. **Refunding** is the exchange of an existing debt instrument with a new one. At the time of redemption, professional judgement must be used to determine whether the transaction represents an extinguishment of the old debt, or a renegotiation or modification of the old debt.

f. **Defeasance** is the setting aside of money in a trust or other arrangement that allows the trust to repay a debt as it becomes due according to the original agreement. Companies enter into this type of arrangement when they want to extinguish or pay off debt before its due date but factors such as early repayment penalties would discourage them from doing so.

Troubled Debt Restructurings

1. Troubled debt restructuring occurs when the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. Such restructuring could be through (a) **settlement** of the debt at less than its carrying amount, or (b) **continuation** of the debt with a modification of terms.

2. If the debt is **settled**, all accounts related to the debt are derecognized from the debtor's books and the debtor will recognize a gain or loss (though usually a gain due to the concessions given by the creditor). The present value of revised cash flows is measured using current market interest rate. The debtor will transfer non-cash assets, issue shares, and/or issue new debt to another creditor and use the cash to repay the existing debt.

3. If concessions are given and a **continuation** is granted, they will be in the form of reduction of the stated interest rate, extension of the maturity date of the debt's face amount, and/or a reduction of the debt's face amount. Under a continuation of debt with **non-substantial modification of terms**: (a) no gain/loss recognized as the old debt is not derecognized, and (b) a new effective interest rate must be calculated for the new debt in order to amortize the carrying value of the existing debt to the face/maturity value of the new debt (such that the carrying value of the old debt equates to cash flows of newly arranged debt).

4. However, in a continuation with modified terms, **substantial modifications** will be treated as a settlement. The modification of terms is "substantial" if either: (a) PV of new cash flow terms is at least 10% different from PV of remaining cash flows under old debt, in which case, the entity uses the original effective interest rate for discounting both sets of cash flows for consistency and comparability, or (b) the old debt is legally discharged and there is a new creditor.

Off-Balance Sheet Financing

1. A significant issue in accounting today is the question of off-balance sheet financing. **Off-balance sheet financing** is an attempt to borrow monies in such a way that the obligations are not recorded. Several examples of off-balance sheet financing are discussed in the chapter as follows:

    a. A **non-consolidated subsidiary** may have considerable debt, for which the parent is ultimately liable. Any exposure under guarantees be recognized on the parent's balance sheet.
    b. **Special Purpose Entities (SPE) or Variable Purpose Entities (VIE)** are entities created by a company to perform a special purpose, such as to access financing, or to segregate certain assets from other company assets, which may allow for certain tax advantages.
    c. Another way that companies keep debt off the statement of financial position is by **leasing** assets instead of buying them with debt.

2. The accounting profession's response to these off–balance sheet financing arrangements has been to tighten up the accounting guidance for guarantees, SPEs, leases, and pensions and also to mandate increased note disclosure requirements.

Presentations and Disclosure

1. Long-term debt that matures within one year should be reported as a current liability unless retirement is to be accomplished with other than current assets.

2. Companies that have large amounts and numerous issues of long-term debt frequently report only one amount in the statement of financial position and support this with comments and schedules in the accompanying notes to the financial statements. These note disclosures generally indicate the nature of the liabilities, maturity dates, interest rates, call provisions, conversion privileges, restrictions imposed by the borrower, and assets pledged as security.

Analysis

1. Ratios helpful in analysing a company's solvency include those that help determine a company's ability to pay interest and to repay long-term debt as it becomes due. Two of these ratios are the **debt-to-total-assets** ratio that measures the percentage of the total assets provided by creditors and **times interest earned** which indicates a company's ability to meet interest payments as they become due.

IFRS/ASPE Comparison

1. Refer to text **Illustration 14-14** which identifies the differences between IFRS and ASPE. The IASB and FASB are also currently working on several projects related to long-term debt, including:

    a. **Financial instruments project**: The IASB and FASB continue to work on IFRS 9, which deals with financial instruments. This standard was meant to eventually replace the current standard (IAS 39). The mandatory adoption date has been deferred to 2015 for IFRS 9 so that the FASB and IASB can continue to study the issues in hopes of bringing about greater convergence..
    b. **Financial instruments with the characteristics of equity**: The IASB paused this project because it had a number of other projects on the go. This will affect how debt and equity instruments are classified and presented on the balance sheet.
    c. **Conceptual framework project**: As part of this project, the standard setters are trying to identify the economic entity for financial reporting purposes and are looking at the definition of control..