The issuance of the notes increases the quick ratio, because Cash increased by $350 million, but the only increase in current liabilities was a relatively small amount of Interest Payable. The $350 million in Notes Payable increased long-term liabilities.

DEMONSTRATION CASE C: BONDS PAYABLE

To raise funds to build a new plant, Reed Company issued bonds with the following terms:

> Face value of the bonds: $100,000.
> Dates: Issued January 1, 2010; due in 5 years on January 1, 2015.
> Interest rate: 6 percent per year, payable on December 31 each year.

The bonds were issued on January 1, 2010, at 104.3, implying a 5 percent market rate of interest. The annual accounting period for Reed Company ends on December 31.

Required:

1. How much cash did Reed Company receive from the issuance of the bonds? Show computations.
2. What was the amount of premium on the bonds payable? Over how many months should it be amortized?
3. Show the accounting equation effects and give the journal entry on January 1, 2010, for recording the issuance of the bonds.
4. (Supplement 10A) Show the accounting equation effects and give the journal entry required on December 31, 2010, relating to interest on the bond. Use the straight-line amortization method.
5. (Supplement 10B) Show the accounting equation effects and give the journal entry required on December 31, 2010, relating to interest on the bond. Use the effective-interest amortization method.
6. (Supplement 10C) Show the accounting equation effects and give the journal entries required on January 1, 2010, relating to the bond issuance and on December 31, 2010, relating to interest on the bond. Use the simplified effective-interest amortization method.

Suggested Solution

1. Issue price of the bonds: $100,000 × 104.3% = $104,300.
2. Premium on the bonds payable: $104,300 − $100,000 = $4,300.
   Months amortized: From date of issue, January 1, 2010, to maturity date, January 1, 2015 = 5 years × 12 months per year = 60 months.
3. January 1, 2010 (issuance date):

Assets	=	Liabilities	+	Stockholders' Equity
Cash +104,300		Bonds Payable +100,000		
		Premium on Bonds Payable +4,300		

dr Cash (+A)	104,300	
cr Premium on Bonds Payable (+L)		4,300
cr Bonds Payable (+L)		100,000

4. December 31, 2010:

Assets	=	Liabilities	+	Stockholders' Equity
Cash −6,000		Premium on Bonds Payable −860		Interest Expense (+E) −5,140

dr Premium on Bonds Payable (−L) ($4,300 × 12/60 months)	860	
dr Interest Expense (+E, −SE) ($6,000 − $860)	5,140	
cr Cash (−A) ($100,000 × 6% × 12/12)		6,000

5. December 31, 2010:

Assets	=	Liabilities	+	Stockholders' Equity
Cash −6,000		Premium on Bonds Payable −785		Interest Expense (+E) −5,215

dr Interest Expense (+E, −SE) ($104,300 × 5% × 12/12)	5,215	
dr Premium on Bonds Payable (−L) ($6,000 − $5,215)	785	
cr Cash (−A) ($100,000 × 6% × 12/12)		6,000

6. January 1, 2010 (issuance date):

Assets	=	Liabilities	+	Stockholders' Equity
Cash +104,300		Bonds Payable, Net +104,300		

dr Cash (+A)	104,300	
cr Bonds Payable, Net (+L)		104,300

December 31, 2010 (interest accrual):

Assets	=	Liabilities	+	Stockholders' Equity
Cash −6,000		Bonds Payable, Net −785		Interest Expense (+E) −5,215

dr Interest Expense (+E, −SE) ($104,300 × 5% × 12/12)	5,215	
dr Bonds Payable, Net (−L) ($6,000 − $5,215)	785	
cr Cash (−A) ($100,000 × 6% × 12/12)		6,000

CHAPTER SUMMARY

LO1 Explain the role of liabilities in financing a business. p. 452

- Liabilities play a vital role in allowing a business to buy goods and services on credit, cover gaps in cash flows, and expand into new regions and markets.
- Liabilities are classified as current if due to be paid with current assets within the current operating cycle of the business or within one year of the balance sheet date (whichever is longer). All other liabilities are considered long term.

LO2 Explain how to account for common types of current liabilities. p. 453

- Liabilities are initially reported at their cash equivalent value, which is the amount of cash that a creditor would accept to settle the liability immediately after the transaction or event occurred.
- Liabilities are increased whenever additional obligations arise (including interest) and are reduced whenever the company makes payments or provides services to the creditor.

LO3 Analyze and record bond liability transactions. p. 460

- For most public issuances of debt (bonds), the amount borrowed by the company does not equal the amount repaid at maturity. The effect of a bond discount is to provide the borrower less money than the value stated on the face of the bond, which increases the cost of borrowing above the interest rate stated on the bond. The effect of a bond premium is to provide the borrower more money than the face value repaid at maturity, which decreases the cost of borrowing below the stated interest rate.
- Interest Expense reports the cost of borrowing, which equals the periodic interest payments plus (or minus) the amount of the bond discount (or premium) amortized in that interest period.

LO4 Describe how to account for contingent liabilities p. 467

- A contingent liability is a potential liability (and loss) that has arisen as a result of a past transaction or event. Its ultimate outcome will not be known until a future event occurs or fails to occur. Under GAAP, it is recorded when likely and estimable.