

## PART VI

### LONG-TERM LIABILITIES

When purchasing assets expected to last a number of accounting periods, long-term liabilities are often used as an alternative to equity financing. Companies choose this method because all the return generated by the assets purchased accrues to the owners upon payment of the debt financing. This results in a higher return on owner's equity than would have resulted had the company used equity financing. Using debt financing in place of equity financing to increase return on equity is called leverage. When small amounts are borrowed from single sources such as a bank, the instrument used is a Notes Payable. Bonds are more convenient when many financial sources are required to fulfill larger financing needs.

#### INSTALLMENT NOTES PAYABLE

Repayment of Notes Payable may be with a single payment as explained in the Learning Unit on Current Liabilities (page 66) or may be paid in installments. Banks may require installments yielding equal principal payments with interest calculated upon the unpaid balance at the beginning of the payment period. Under this method, the principal declines an equal amount each period, annual interest declines, as does the annual payment. Alternatively, banks may require equal

payments per period. In this case, the loan amount is the present value of a number of equal payments discounted at the interest rate charged by the bank. Under this situation annual interest is equal to the discount rate times the beginning-of-period principal (BOP). Because the payments and not the decline in principal are equal, the BOP principal and interest must be recalculated periodically. This procedure will become clearer upon reading this Learning Unit.

#### BONDS PAYABLE

Bonds are debt securities, usually long-term in nature, issued by a corporation or government to the investing public. Bonds may be secured by assets or be unsecured (debentures). The bonds of a particular issue may all come due at the same time (Term Bonds) or the

Bonds pay a predetermined, fixed interest rate which may or may not be the rate required by the investing public at the time of issue or over the life of the bonds. The actual amount received for a bond is the present value of the interest payments plus the present value of the principal, both discounted at a rate the investing public associates with the riskiness of the bond issue. This results in investors paying a Premium if the

maturities may be spread over a number of years (Serial Bonds). Corporations issuing Registered Bonds send semiannual interest payments directly to investors. Investors in Coupon Bonds must send dated coupons to the corporation to receive their interest.

interest paid is higher than that which investors require as determined by their perception of the risk associated with the bond issue. If the rate paid is too low, the buying public pays less than face value and the issuer sells at a discount. Corporations charge premiums received and discounts paid to interest expense over the life of the issue using either the Straight Line Method or the Effective Interest Method.