Balance Sheet: Reporting Liabilities

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Course Description

This course discusses the accounting, reporting, and disclosures associated with liabilities on the balance sheet. It includes items covered in ASC 210-10-45-5 through 45-12 and 470-10, *Balance Sheet: Overall*. Topics include loss contingencies, compensated absences, termination benefits, troubled debt restructuring, refinancing of current to noncurrent debt, callable obligations by creditors, issuance of bonds, calling debt, imputing interest on noninterest notes payable, environmental liabilities, and offsetting of liabilities.

Field of Study	Accounting
Level of Knowledge	Basic
Prerequisite	Basic Accounting
Advanced Preparation	None

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Chapter 1:

Current Liabilities and Contingencies

Learning Objectives:

After completing this chapter, you should be able to:

- Identify classification and characteristics of current and long-term liabilities
- Apply the appropriate rule to account for different types of loss contingencies.
- Recognize rules for the troubled debt, impairment of loans, and restructuring of debt.

Current Liabilities

A liability is liquidated from either the use of an asset or the incurrence of another liability. Liabilities may arise from a contract, by law, by a judicial decision, or by another means.

Current liabilities are those to be paid or liquidated from current assets or created from other current liabilities. Current liabilities are due on demand or within one year or the normal operating cycle of the business, whichever is greater. Current liabilities include (1) obligations that by their terms are or will be due on demand within 1 year (or the operating cycle, if longer), and (2) obligations that are or will be callable by the creditor within 1 year because of a violation of a debt covenant. An exception exists, however, if the creditor has waived or subsequently lost the right to demand repayment for more than 1 year (or the operating cycle, if longer) from the balance sheet date.

Accounts payable, commonly termed trade accounts payable, are liabilities reflecting the obligations to sellers that are incurred when an entity purchases inventory, supplies, or services on credit. Accounts payable should be recorded at their settlement value. Short-term liabilities, such as accounts payable, do not usually provide for a periodic payment of interest unless the accounts are not settled when due or payable. They also are usually not secured by collateral.

Deferred revenue is a liability that is created when monies are received by a company for goods and services not yet provided. Revenue will be recognized, and the deferred revenue liability eliminated,

when the services are performed. For example, revenue from a gift certificate is realized when the cash is received. However, it is not earned until the certificate expires or is redeemed. Consequently, when a gift certificate is issued, the company receiving the cash should record the issuance as a deferred revenue. A customer deposit is a liability because it involves a probable future sacrifice of economic benefits arising from a current obligation of a particular entity to transfer assets or provide services to another entity in the future as a result of a past transaction.

Current liabilities may arise in which:

- The payee and amount are known.
- The payee is not known but the amount may be reasonably estimated.
- The payable is known but the amount must be estimated.
- The liability arises from a loss contingency.

The current portion of long-term debt to be paid within the next year or the amount that is due on demand is classified as a current liability.

Refundable deposits are classified as current liabilities if the company intends to refund the money within the next year.

Agency liabilities are amounts withheld by the company from employees or customers for taxes owed to federal, state, or local taxing agencies. They are listed as current liabilities.

A company may offer potential customers premiums (something free or for a minimal charge, such as samples) to stimulate product sales. The customer may be required to return evidence of purchase of certain products (e.g., box top) to get the premium. A nominal cash payment may be necessary. A current liability arises for the amount of anticipated redemptions in the next year. If the premium and redemption period is for more than one year, an estimated liability must be allocated to the current and noncurrent portions.

EXAMPLE

XYZ Company offers its customers a camera in exchange for 20 boxtops and $3. The camera costs the company $18. It is expected that 60% of the boxtops will be redeemed. The following journal entries are required:

1. To record the purchase of 10,000 cameras at $18 each:

Inventory of premium cameras	180,000	
Cash		180,000

2. To record the sale of 400,000 boxes of the company's major product at $3 each:

Cash	1,200,000	
Sales		1,200,000

3. To record the actual redemption of 120,000 boxtops, the receipt of $3 per 20 boxtops, and the delivery of the cameras:

Cash [(120,000/20 × $3)]	18,000	
Premium expense	90,000	
Inventory of premium cameras [(120,000/20) × $18]		108,000

4. To record end-of-year adjusting entry for estimated liability for outstanding offers (boxtops):

Premium expense	90,000	
Estimated liability		90,000

Computation:

Total boxtops sold	400,000
Total estimated redemptions (60%)	240,000
Boxtops redeemed	120,000
Estimated future redemptions	120,000

Cost of estimated claims outstanding (120,000/20) × ($18 - 3) = $90,000

Note: The premium expense account is presented as a selling expense. The inventory of premium cameras account balance is presented as a current asset, and the estimated liability account is reported as a current liability.

EXAMPLE

On November 30, 2X13, a consignee received 1,000 units on consignment. The cost and selling price per unit were $60 and $85, respectively. The commission rate is 8%. At December 31, 2X13, the units in inventory were 200. The amount to be presented as a payable for consigned goods at year-end 2X13 is computed as follows:

Units sold (1,000 - 200) × Amount to be remitted per	800

unit ($85 - $6.80)	
	× $78.20
Payable	$62,560

ASC 470-10-45-9 covers the classification of demand notes with repayment terms. Obligations due on demand or within one year are classified as current debt even if liquidation is not anticipated within that period.

ASC 470-10-45-4, *Debt: Overall*, deals with the balance sheet classification of borrowings outstanding under revolving credit agreements that include both a subjective acceleration clause and a lock-box agreement. If the borrowings reduce the debt outstanding, the borrowings are classified as current liabilities.

EXAMPLE

Shapiro Company presented the following, liabilities at year-end 2X12:

Accounts payable	$100,000
Notes payable, 10%, due 7/1/2X13	600,000
Contingent liability	150,000
Accrued expenses	20,000
Deferred income tax credit	25,000
Bonds payable, 9%, due 5/1/2X13	500,000

The contingent liability represents a reasonably possible loss arising from a $400,000 lawsuit against Shapiro. In the opinion of legal counsel, the lawsuit is expected to be resolved in 2X14. The range of loss is $200,000 to $600,000. The deferred income tax credit is expected to reverse in 2X14.

At year-end 2X12, current liabilities equal $1,220,000, computed as follows:

Accounts payable	$ 100,000
Notes payable, due 5/1/2X13	600,000
Accrued expenses	20,000
Bonds payable, due 5/1/2X13	500,000
Total	$1,220,000

EXAMPLE

Morgan Company requires nonrefundable advance payments with special orders for equipment built to customer specifications. The following data were provided for 2X13:

Customer advances 1/1/2X13	$300,000
Advances related to canceled orders during the year	80,000
Advances for orders shipped during the year	160,000
Advances received with orders during the year	200,000

The amount to be presented as a current liability for customer advances at year-end 2X13 is computed as follows:

Balance—1/1/2X13	$300,000
Add: advances received with orders	200,000
Less: advances related to orders canceled	(80,000)
Less: advances for orders shipped	(160,000)
Balance—12/31/2X13	$260,000

EXAMPLE

Schwartz Company requires an advance payment for orders specially designed for particular customers. Such advances are not refundable. Relevant information for 2X13 follows:

Customer advances—1/1/2X13	$69,000
Advances associated with canceled orders	30,000
Advances received with orders	90,000
Advances applied to orders shipped	85,000

On December 31, 2X13, the current liabilities associated with customer advances was $44,000, computed as follows:

Balance—1/1/2X13	$69,000
Add: advances received with orders	90,000
Less: advances applicable to orders shipped	(85,000)
Less: advances related to canceled orders	(30,000)
Balance—12/31/2X13	$44,000

EXAMPLE

On December 31, 2X13, Fox Company received 200 units of a product on consignment from Jacoff Company. The cost of the product is $50 each, and the selling price per unit is $75. Fox's commission is 8%. At December 31, 2X13, 10 units were in stock. The payable for consigned goods to be shown under current liabilities is $13,110, computed as follows:

Units sold (200 - 10)	190
Per unit owed ($75 selling price less $6 commission)	× $69
Total	$13,110

EXAMPLE

As of December 31, 2X12 before adjustment for the following items, accounts payable had a balance of $700,000:

- A check to a supplier amounting to $40,000 was recorded on December 30, 2X12. The check was mailed on January 3, 2X13.
- At December 31, 2X12, the company has a $30,000 debit balance in its accounts payable to a supplier due to an advance payment for a product to be produced.

The accounts payable to be presented on the December 31, 2X12 balance sheet is computed as follows:

Unadjusted balance	$700,000
Unmailed check	40,000
Customer with debit balance	30,000
Adjusted balance	$770,000

Noncurrent Liabilities

Debt is classified as **noncurrent** if it is to be refinanced with another long-term issue or extinguished from noncurrent assets (e.g., sinking fund). It is not to be paid from current assets or the incurrence of current liabilities.

Long-term debt should be recorded at the **present value discounted of future payments using the market rate of interest.**

Derivatives and liabilities arising from the transfer of financial assets are recorded at fair market value.

In a deferred interest-rate-setting agreement that is an important element in the original issuance, amounts paid or received because of such agreement should be treated as a premium or discount on the initial debt and amortized over the term of the debt. In a deferred interest rate arrangement, the issuing company sells its debt at a fixed rate but also contracts to set an interest rate at a later date based on some index. As a result, the set interest rate will differ from the fixed interest rate during the designated period.

If a borrowing arrangement permits the debtor to redeem the debt instrument within one year, it is presented under current liabilities. However, the debt is classified as noncurrent if the letter of credit agreement satisfies the following criteria:

- The financing agreement does not terminate within one year.
- The refinancing is on a long-term basis.
- The lender cannot cancel the agreement unless there is a clearly ascertainable violation.

If debt is tied to a certain index or market value of a commodity so that a contingent payment will be due at maturity, a liability must be recorded for the amount by which the contingent payment exceeds the amount initially assigned to the contingent payment feature.

In a joint venture, there may be take-or-pay or throughput contracts to construct capital facilities (e.g., factory building). The debt is incurred by the joint venture, but the individual companies buy the goods (take-or-pay contract) or services (throughput contract) arising from the project. The goods or services are paid for periodically, irrespective of whether the items are delivered or not. A minimum amount of goods or services is usually provided for. Such agreements require disclosure.

An indirect guarantee of indebtedness of others is an assurance obligating one company (the first company) to transfer money to a second company upon the occurrence of some happening, whereby the funds are available to creditors of the second company, and those same creditors have a legal right to collect from the first company debt owed by it to the second company.

ASC 470-10-35, *Debt: Overall*, stipulates that notes maturing in three months having a continual extension option for up to five years may be classified after taking into account the intentions of the parties and the issuer's ability to pay the debt. If the source of repayment is current, the debt should be classified as current. However, if the source of repayment is noncurrent, the debt is noncurrent in nature. Interest should be computed based on the interest method. Debt interest costs should be deferred and amortized over the outstanding period of the debt. If excess accrued interest arises from paying the debt before maturity, it should be used to adjust interest expense.

Note: Classification of the debt need not be the same as the period used to compute periodic interest cost.

EXAMPLE

A company has an escrow account from which it pays property taxes on behalf of customers. Interest less a 5% service fee is credited to the mortgagee's account and is used to reduce future escrow payments. Additional data are as follows:

ESCROW ACCOUNTS LIABILITY—BEGINNING OF YEAR	$500,000
Receipt of escrow payments	800,000
Payment of property taxes	450,000
Interest earned on escrow funds	65,000

At year-end, the escrow accounts liability equals $911,750, determined as follows:

Balance—1/1	$500,000
Receipt of escrow payments	800,000
Payment of property taxes	(450,000)
Interest earned net of service fee ($65,000 × 95%)	61,750
Balance—12/31	$911,750

Disclosures for debt include:

- Type of debt (e.g., debentures, secured).
- Major classes of debt.
- Pledging or collateral requirements.
- Stated interest rate.
- Restrictive covenants (e.g., dividends limitations, working capital requirements).
- Maturity value, maturity period, and maturity date.
- Open lines of credit.
- Conversion options.
- Unused letters of credit.
- Sinking fund requirements.
- Amounts due to related parties.
- Amounts due to officers.

Chapter 1 Review Questions

1. Delhi Co. is preparing its financial statements for the year ended December 31, 2002. Accounts payable amounted to $360,000 before any necessary year-end adjustment related to the following: 1) At December 31, 2002, Delhi has a $50,000 debit balance in its accounts payable to Madras, a supplier, resulting from a $50,000advance payment for goods to be manufactured to Delhi's specifications. 2) Checks in the amount of $100,000 were written to vendors and recorded on December 29, 2002. The checks were mailed on January 5, 2003. What amount should Delhi report as accounts payable in its December 31, 2002 balance sheet?

A. $510,000

B. $410,000

C. $310,000

D. $210,000

2. According to GAAP, long-term obligations that are or will become callable by the creditor because of the debtor's violation of a provision of the debt agreement at the balance sheet date should be classified as

A. Long-term liabilities.

B. Current liabilities unless the creditor has waived the right to demand repayment for more than 1 year from the balance sheet date.

C. Contingent liabilities until the violation is corrected.

D. Current liabilities unless it is reasonably possible that the violation will be corrected within the grace period.

3. Buc Co. receives deposits from its customers to protect itself against nonpayments for future services. These deposits should be classified by Buc as

A. A liability.

B. Revenue.

C. A deferred credit deducted from accounts receivable.

D. A contra account.

4. A company receives an advance payment for special order goods that are to be manufactured and delivered within 6 months. The advance payment should be reported in the company's balance sheet as a

A. Deferred charge.

B. Contra asset account.

C. Current liability.

D. Noncurrent liability.

5. A retail store received cash and issued a gift certificate that is redeemable in merchandise. When the gift certificate was issued, a

A. Deferred revenue account should be decreased.

B. Deferred revenue account should be increased.

C. Revenue account should be decreased.

D. Revenue account should be increased.

Fair Value Measurements

ASC 820-10-05, *Fair Value Measurements and Disclosures: Overall*, provides the definition of fair value, gives guidance on fair value measurements, and cites suitable disclosures in the financial statements of the measures of fair value used. Fair value is a market-based measurement. A fair value measurement reflects current market participant assumptions regarding future inflows of the asset and future outflows of the liability. A fair value measurement should take into account features of the specific asset or liability such as condition and location.

In deriving fair value, exchange price should be examined. This is the market price at the measurement date in an "orderly transaction" between the parties to sell the asset or transfer the liability. Specifically, focus is on the price at the measurement date that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to buy the asset or received to assume the liability (an entry price). In addition, the asset or liability may be independent (e.g., financial instrument, operating asset), or there may be a group of assets or liabilities (e.g., asset group, reporting unit).

To consider the assumptions of market participants in fair value measurements, ASC 820-10-05 provides a hierarchy of fair value that differentiates between (1) assumptions based on market data obtained from independent outside sources to the reporting entity (observable inputs) and (2) assumptions by the reporting entity itself (unobservable inputs). The use of unobservable inputs allows for situations in which there is minimal or no market activity for the asset or liability at the measurement date. In this scenario, the reporting entity need not perform all possible efforts to obtain information concerning market participant assumptions. However, the entity must not ignore information of reasonably available market participant assumptions. Valuation techniques used to measure fair value shall maximize the use of observable inputs and minimize the use of unobservable inputs.

Market participant assumptions include risk, such as risk in a specific valuation method to measure fair value (e.g., pricing model) or input risks to the valuation technique. An adjustment for risk should be made in a fair value measurement when market participants would include risk in the pricing of the asset or liability. Market participant assumptions should consider the impact of a restriction on the sale or use of an asset that influences its price.

A fair value measurement for a liability should take into account the risk that the obligation will not be fulfilled (nonperformance risk). In evaluating this risk, the reporting entity's credit risk should be considered.

The fair value of a position in a financial instrument (including a block) that is actively traded should be measured by multiplying the quoted price of the instrument by the quantity held (within Level 1 of the fair value hierarchy). The quoted price must not be adjusted because of the size of the position relative to trading volume (blockage factor).

A fair value measurement assumes the transaction takes place in the principal market for the asset or liability. The principal market is one in which the reporting entity would sell the asset or transfer the liability with the greatest volume and activity level. If there is no principal market, then the most advantageous market should be used. The most advantageous market is one in which the reporting entity would sell the asset or transfer the liability with the price that maximizes the amount that would be received for the asset or minimizes the amount that would be paid to transfer the liability after considering transaction costs.

The price in the principal (or most advantageous) market used to measure fair value should not be adjusted for transaction costs. On the other hand, transportation costs for the asset or liability should be included in the fair value measurement.

In measuring fair value, valuation techniques in conformity with the market, income, and cost approaches should be used. Under the "market approach," prices for market transactions for identical or comparable assets or liabilities are used. An example of a market approach is matrix pricing. This is a mathematical method used primarily to value debt securities without solely relying on quoted prices for the particular securities. This method relies on the relationship of the securities to other benchmark quoted securities. Under the "income approach," valuation techniques are used to convert future amounts (e.g., profits, cash flows) to a present value amount. For example, future cash flows are discounted to their present value amount using the present value tables (Tables 1 and 2 in the Appendix). The measurement is based on market expectations of the future amounts. Examples of these valuation techniques are present value determination, option pricing models, and the multiyear excess earnings method (to value goodwill). The "cost approach" is based on the amount that would be required to replace an asset's service capability (current replacement cost). An example is the cost to purchase or build a substitute asset of comparable utility after adjusting for obsolescence.

Depending on the circumstances, a single or multiple valuation technique may be needed. For example, a single valuation method would be used to value an asset using quoted prices in an active market for identical assets, whereas a multiple valuation method would be used to value a reporting unit.

Input availability and reliability associated with the asset or liability may influence the selection of the best-suited valuation method.

The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The levels range from the highest priority, which is assigned to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1), to the lowest priority, which is assigned to unobservable inputs (Level 3).

Level 2 inputs are those (except quoted prices included within Level 1) that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Included as Level 2 inputs are:

- Quoted prices for similar assets or liabilities in active markets.

- Quoted prices for similar or identical assets or liabilities in markets that are not active namely in markets having few transactions, noncurrent prices, price quotations that vary significantly, or very limited public information.
- Inputs excluding quoted prices that are observable for the asset or liability. Examples are interest rates observable at often quoted intervals, default rates, credit risks, loss severities, volatilities, and prepayment speeds.
- Inputs derived in most part from observable market data by correlation or other means.

Adjustments to Level 2 inputs vary depending on factors specific to the asset or liability. Those factors include the location or condition of the asset or liability, market volume and activity level, and the extent to which the inputs relate to comparable items to the asset or liability. A major adjustment to the fair value measurement may result in a Level 3 measurement.

Level 3 inputs are unobservable for the asset or liability. Unobservable inputs are used to measure fair value to the extent that observable inputs are unavailable. This allows for cases in which there is little or no market activity for the asset or liability at the measurement date. Unobservable inputs reflect the reporting entity's own assumptions about the assumptions (e.g., risk) that market participants would use in pricing the asset or liability.

If an input used to measure fair value is based on bid and ask prices, the price within the bid-ask spread that is most representative of fair value shall be used to measure fair value regardless of where in the fair value hierarchy the input falls.

Disclosures are mandated for fair value measurements to improve financial statement user understanding. Quantitative disclosures using a tabular format are required in all periods (annual and interim). Qualitative (narrative) disclosures are required about the valuation methods used to measure fair value. Disclosures of fair value in measuring assets and liabilities emphasizes the inputs used to measure fair value and the impact of fair value measurements on profit or change in net assets.

For assets and liabilities measured at fair value on a recurring basis in periods after initial recognition (e.g., trading securities), disclosures should be made to allow financial statement users to appraise the inputs used to formulate fair value measurements. To achieve this, the following should be disclosed in annual and interim periods for each major category of asset and liability:

1. Fair value measurements at the reporting date.

2. The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating the fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), major other observable inputs (Level 2), and significant unobservable inputs (Level 3).

3. For fair value measurements using major unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:

a. Total gain or loss (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets) as well as where those gains or losses are presented in the financial statements.

b. Purchases, sales, issuances, and settlements (net).

c. Transfers in or out of Level 3. An example is a transfer because of a change in the observability of major inputs.

4. For annual reporting only, the valuation techniques used to measure fair value and a discussion of any changes in those techniques.

For assets and liabilities that are measured at fair value on a nonrecurring basis in periods after initial recognition such as impaired assets, disclosure should be made of:

1. The level within the fair value hierarchy in which the fair value measurements fall.

2. Fair value measurements recorded during the period and the reasons for those measurements.

3. For fair value measurements using significant unobservable inputs (Level 3), a description of the inputs and the data used to develop them.

4. For annual reporting only, the valuation methods used and any changes in them to measure similar assets and liabilities in prior years.

ASC 820, *Fair Value Measurement*, provides guidance for estimating fair value when the volume and activity level for the asset or liability have significantly decreased. This includes guidance on identifying circumstances that indicate a transaction is not orderly. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (i.e., not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions.

If the reporting entity decides there has been a major decrease in the volume and level of activity for the asset or liability relative to normal market activity for the asset or liability, transactions or quoted prices may not be determinative of fair value. Further analysis is needed, and a significant adjustment to the transaction or quoted prices may be necessary to estimate fair value. Significant adjustments also may be needed in other situations (for instance, when a price for a similar asset requires significant adjustment to make it more comparable to the asset being measured or when the price is old).

Even in cases where there has been a significant decrease in the volume and level of activity for the asset or liability regardless of the valuation technique used, the objective of a fair value measurement remains the same. Determining the price at which willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and

requires the use of judgment. However, a reporting entity's intention to hold the asset or liability is not relevant in estimating fair value. Fair value is a market-based measurement, not an entity-specific measurement.

Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced).

Accounting Standards Update (ASU) No. 2011-04 (May 2011) (ASC 820, *Fair Value Measurement*), *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*, provides the following amendments to ASC 820:

• The concepts of highest and best use and valuation in a fair value measurement are only relevant in measuring the fair value of nonfinancial assets, *not* financial assets or liabilities.

• A company should measure the fair value of its own equity instrument from the point of view of a holder of that instrument.

• A company should disclose quantitative data concerning unobservable inputs used to measure fair value classified in Level 3.

• The application of discounts or premiums in a fair value measurement applies to the unit of account for the asset or liability being measured at fair value.

In the case of a Level 3 fair value hierarchy, disclosure should be made of the valuation processes as well as the sensitivity of the fair value measurement to changes in unobservable inputs and any interrelationships between them.

Fair Value Option for Financial Assets and Financial Liabilities

ASC 825-10-05, 10-10 and 10-15, *Financial Instruments: Overall*, allows companies to measure many financial instruments and some other items at fair value. The pronouncement is effective as of the beginning of the company's first fiscal year beginning after November 15, 2007. Most provisions of the pronouncement solely apply to businesses that choose the fair value option. The eligible items for the fair value measurement option are:

1. Recognized financial assets and financial liabilities excluding
    a. financial assets and financial liabilities recognized under leases,

b. financial instruments classified by the issuer as an element of stockholders' equity such as a convertible bond with a noncontingent beneficial conversion feature,

c. investment in a subsidiary or variable interest entity that must be consolidated,

d. deposit liabilities that can be withdrawn on demand of banks, and

e. employers' plan obligations or assets for pension and postretirement benefits.

2. Nonfinancial insurance contracts and warranties that can be settled by the insurer by paying a third party for goods or services.

3. Firm commitments applying to financial instruments such as a forward purchase contract for a loan not readily convertible to cash.

4. Written loan commitment.

5. Host financial instruments arising from separating an embedded nonfinancial derivative instrument from a nonfinancial hybrid instrument.

GAAP permits a company to choose to measure eligible items at fair value at stipulated election dates. Included in earnings at each reporting date are the unrealized (holding) gains and losses on items for which the fair value option has been elected.

The fair value option is irrevocable (except if a new election date occurs) and is applied solely to entire instruments (not portions of those instruments or specified risks or specific cash flows). In most cases, the fair value option may be applied instrument-by-instrument including investments otherwise accounted for under the equity method.

These parameters (ASC 825-10-15, 4-5) apply to all companies with trading and available-for-sale securities.

Upfront costs and fees applicable to items for which the fair value option is selected are expensed as incurred.

Electing the Fair Value Option

A company may elect the fair value option for all eligible items only on the date that one of the following occurs:

1. The company first recognizes the eligible item.

2. The company engages in an eligible firm commitment.

3. There is a change in the accounting treatment for an investment in another company because the investment becomes subject to the equity method or the investor no longer consolidates a subsidiary because a majority voting interest no longer exists, although the investor still retains some ownership interest.

4. Specialized accounting treatment no longer applies for the financial assets that have been reported at fair value such as under an AICPA Audit and Accounting Guide.

5. An event mandates an eligible item to be measured at fair value on the event date but does not require fair value measurement at each subsequent reporting date.

Events

Some events that require remeasurement of eligible items at fair value, initial recognition of eligible items, or both, and thus create an election date for the fair value option are:

- Consolidation or deconsolidation of a subsidiary or variable interest entity.
- Business combination.
- Sale of a portion of a consolidated subsidiary; any previously recorded noncontrolling interest must be measured at fair value.
- Major debt modification.

Instrument Application

The fair value option may be selected for a single eligible item without electing it for other identical items except for the following:

1. If the fair value option is selected for an eligible insurance contract, it must be applied to all claims and obligations under the contract.

2. If the fair value option is selected for an investment under the equity method, it must be applied to all of the investor's financial interests in the same entity that are eligible items.

3. If multiple advances are made to one borrower under a single contract (e.g., construction loan) and the individual losses lose their identity and become part of the larger loan, the fair value option must be applied to the larger loan balance but not to the individual advances.

4. If the fair value option is selected for an insurance contract for which integrated or nonintegrated contract features or riders are issued at the same time or later, the fair value option must be applied also to those features or coverage.

The fair value option does not usually have to be applied to all financial instruments issued or bought in a single transaction. For example, an investor in stock or bonds may apply the fair value option to some of the stock shares or bonds issued or acquired in a single transaction. In this case, an individual bond is considered the minimum denomination of that debt security. A financial instrument that is a single contract cannot be broken down into parts when using the fair value option. However, a loan syndication may consist of in multiple loans to the same debtor by different creditors. Each of the loans is a separate instrument, and the fair value option may be selected for some of the loans but not others.

An investor in an equity security may choose the fair value option for its entire investment in that security including any fractional shares.

Balance Sheet

Companies must report assets and liabilities measured at the fair value option in a way that separates those reported fair values from the book (carrying) values of similar assets and liabilities measured with a different measurement attribute. To achieve this, a company must either:

- Report the aggregate fair value and nonfinancial fair value amounts in the same line items in the balance sheet and, in parenthesis, disclose the amount measured at fair value included in the aggregate amount.
- Report two separate line items to display the fair value and nonfair value carrying amounts.

Statement of Cash Flows

Companies must classify cash receipts and cash payments for items measured at fair value based on their nature and purpose.

Disclosures

Disclosures of fair value are required in annual and interim financial statements.

When a balance sheet is presented, the following must be disclosed:

1. The reasons why the company selected the fair value option for each allowable item or group of similar items.

2. In the event the fair value option is chosen for some but not all eligible items within a group of similar items, management must describe those similar items and the reasons for partial election. In addition, information must be provided so that financial statement users can comprehend how the group of similar items applies to individual line items on the balance sheet.

3. For every line item on the balance sheet that includes an item or items for which the fair value option has been selected, management must provide information on how each line item relates to major asset and liability categories. In addition, management must provide the aggregate carrying amount of items included in each line item that are not eligible for the fair value option.

4. To be disclosed is the difference between the aggregate fair value and the aggregate unpaid principal balance of loans, long-term receivables, and long-term debt instruments with contractual principal amounts for which the fair value option has been chosen.

5. In the case of loans held as assets for which the fair value option has been selected, management should disclose the aggregate fair value of loans past due by 90 days or more. If the company recognizes interest revenue separately from other changes in fair value, disclosure should be made of the aggregate fair value of loans in the nonaccrual status. Disclosure should also be made of the difference between the aggregate fair value and aggregate unpaid principal balance for loans that are 90 days or more past due or in nonaccrual status.

6. Disclosure should be made of investments that would have been reported under the equity method if the company did not elect the fair value option.

When an income statement is presented, the following must be disclosed:

1. An enumeration of how dividends and interest are measured and where they are presented in the income statement.

2. Gains and losses from changes in fair value included in profit and where they are shown.

3. For loans and other receivables, the estimated amount of gains and losses (including how they were calculated) included in earnings associated with changes in instrument-specific credit risk.

4. For liabilities with fair values that have been materially impacted by changes in the instrument-specific credit risk, the estimated amount of gains and losses from fair value changes (including how they were calculated) applicable to changes in such credit risk, and the reasons for those changes.

Other disclosures include the methods and assumptions used in fair value estimation. Also to be disclosed is qualitative information about the nature of the event as well as quantitative information, including the impact on earnings of initially electing the fair value option for an item.

Eligible Items at Effective Date

A company may select the fair value option for eligible items at the effective date. The difference between the book (carrying) value and the fair value of eligible items chosen for the fair value option at the effective date must be removed from the balance sheet and included in the cumulative-effect adjustment. These differences include: (1) valuation allowances (e.g., loan loss reserves); (2) unamortized deferred costs, fees, discounts and premiums; and (3) accrued interest associated with the fair value of the eligible item.

A company that selects the fair value option for items at the effective date must provide, in the financial statements that include the effective date, the following:

1. The impact on deferred tax assets and liabilities of selecting the fair value option.
2. The reasons for choosing the fair value option for each existing eligible item or group of similar items.
3. The amount of valuation allowances removed from the balance sheet because they applied to items for which the fair value option was selected.
4. The schedule presenting the following by line items in the balance sheet: (a) before tax portion of the cumulative-effect adjustment to retained earnings for the items on that line and (b) fair value at the effective date of eligible items for which the fair value option is selected and the book (carrying) amounts of those same items immediately before opting for the fair value option.
5. In the event the fair value option is selected for some but not all eligible items within a group of similar eligible items, a description of similar items and the reasons for the partial election. In addition, information should be provided so financial statement users can comprehend how the group of similar items applies to individual items on the balance sheet.

Available-for-Sale and Held-to-Maturity Securities

Available-for-sale and held-to-maturity securities held at the effective date are eligible for the fair value option at that date. In the event that the fair value option is selected for any of those securities at the effective date, cumulative holding (unrealized) gains and losses must be included in the cumulative-

effect adjustment. Separate disclosure must be made of the holding gains and losses reclassified from accumulated other comprehensive income (for available-for-sale securities) and holding gains and losses previously unrecognized (for held-to-maturity securities).

ASC 825, *Financial Instruments*, states that disclosures are required about fair value of financial instruments for interim periods of public companies. A company must disclose in the body or notes to the summarized financial information the fair value of all financial instruments for which it can practically estimate fair value, whether recognized or not recognized in the balance sheet.

Fair value information disclosed in the notes shall be presented along with the related carrying amount of the asset or liability. Disclosure shall also be made of the method(s) and major assumptions used to estimate fair value of financial instruments and describe any changes in method(s) and significant assumptions.

Accounting Standards Update (ASU) No. 2009-05 (August 2009) (ASC 820, *Fair Value Measurements and Disclosures*), *Measuring Liabilities at Fair Value*, provides information on the following:

- Offers guidance for identifying fair value in an active market. The best indication of fair value is the price in an active market. The quoted price is a Level 1 measurement. If a quoted priced for an identical liability is not present, fair value may be measured based on the prevailing price for an identical liability traded as an asset. An income method using present value or a market method may also be used (ASC 820-10-35-41).
- Discusses the measurement of fair value. In measuring fair value, there is a presumption of an exchange of debt in an orderly way. In reality, the transfer of liabilities is rare; certain liabilities are traded as assets (ASC 820-10-35-16A).
- States that observable inputs should be maximized and unobservable inputs should be minimized (ASC 820-10-35-16C).
- Specifies that in measuring the fair value of a liability, the quoted price of the asset should not be adjusted for any limitation on its sale (ASC 820-10-35-16D).
- States that in valuing a liability, an independent input applicable to a limitation on liability transfer should not be included (ASC 820-10-35-16E).
- Explains that a Level 1 valuation for a liability is the quoted price in an active market. If the quoted price is adjusted, the liability has a lower level measured fair value associated with it (ASC 820-10-35-41A).
- Discusses Level 2 inputs, which, when modified, vary based on asset or liability characteristics. Factors include asset or liability status and location, activity and volume levels, and comparability of inputs (ASC 820-10-35-50).

Accounting Standards Update (ASU) No. 2010-06 (January 2010) (ASC 820, *Fair Value Measurements and Disclosures*), *Improving Disclosures about Fair Value Measurements*, provides that a transfer between Levels 1 and 2 must be footnoted along with the reasons. (ASC 820-10) Gross information should be furnished for Level 3 items such as for sales. Each type of asset and liability must have a disclosure as to how fair value was determined. Valuation methods should be disclosed including inputs used (ASC 820-10-50-2).

Estimated Liabilities and Contingencies

GAAP (ASC 410-50-05-5) requires that a loss contingency be accrued if both of the following conditions are satisfied:

1. At year-end, it is probable (likely to occur) that an asset was impaired or a liability was incurred.
2. The amount of loss may be reasonably estimated.

Examples of loss contingencies are pending or threatened lawsuits, warranties or defects, assessments and claims, expropriation of property by a foreign government, environmental remediation guarantees of indebtedness, and agreement to repurchase receivables that have been sold. The accrual is required because of the conservatism principle.

The journal entry to record a probable loss contingency is:

Expense (loss)
    Estimated liability

EXAMPLE

On December 31, 2X12, warranty expenses are estimated at $30,000. On March 2, 2X13, actual warranty costs paid were $27,000. The journal entries are:

12/31/2X12	Warranty expense	30,000	
	Estimated liability		30,000
3/2/2X13	Estimated liability	27,000	
	Cash		27,000

If a probable loss cannot be estimated, it should be footnoted.

If there is a loss contingency at year-end but no asset impairment or liability incurrence exists (e.g., uninsured equipment), footnote disclosure should be made.

If there is a loss contingency occurring after year-end but before the audit report date, subsequent event disclosure should be made. An explanatory paragraph should be provided regarding the contingency.

If the loss amount is within a range, the accrual should be based on the best estimate within that range. If no amount within the range is better than any other amount, the **minimum amount** (not maximum amount) of the range should be accrued. There should be disclosure of the maximum loss. If later events indicate that the minimum loss initially accrued is insufficient, an additional loss must be accrued in the year this becomes evident. This accrual is treated as a change in estimate.

EXAMPLE

XYZ Company is involved in a tax dispute with the Internal Revenue Service (IRS). As of December 31, 2X13, XYZ Company believed that an unfavorable outcome is probable and the amount of loss may be in the range of $2.5 million to $3.5 million. After year-end, when the 2001 financial statements had been issued, XYZ Company settled with the IRS and accepted an offer of $3 million. Because a range of loss is involved, it is appropriate to accrue the minimum amount or $2.5 million for 2001 year-end.

If there exists a reasonably possible loss (more than remote but less than likely), no accrual should be made. However, footnote disclosure is required. The disclosure includes the nature of the contingency and the estimated probable loss or range of loss. In the event an estimate of loss cannot be made, that fact should be stated.

A remote contingency (slight chance of occurring) is typically ignored, with no disclosure required.

Exceptions: Disclosure is made of agreements to repurchase receivables, indebtedness guarantees (direct or indirect), and standby letters of credit.

EXAMPLE

A company cosigned a loan guaranteeing the indebtedness if the borrower defaults on it. The likelihood of default is remote. This is an exception to the rule that remote

contingencies need not be disclosed, because it represents a guarantee of indebtedness and thus requires disclosure.

No accrual is made for general (unspecified) contingencies, such as for self-insurance and hurricane losses. However, footnote disclosure and appropriation of retained earnings can be made for such contingencies. To be accrued, the future loss must be specific and measurable, such as freight or parcel post losses.

Gain contingencies can never be booked because doing so violates conservatism. However, footnote disclosure should be made.

Warranty obligations are contingencies and estimates. They may be based upon prior experience, experience of other firms in same industry, or estimates by specialists, such as engineers. If the warranty liability cannot be reasonably estimated, then significant uncertainty exists as to whether a sale should be reported, and another method, such as the installment sales method, cost recovery method, or some other method of revenue recognition used.

Unasserted claims exist when the claimant has elected not to assert the claim or because the claimant lacks knowledge of the existence of the claim. If it is probable that the claimant will assert the unasserted claim, and it is either probable or reasonably possible that the outcome will be unfavorable, the unasserted claim should be disclosed in the financial statements.

Contingent consideration in a business combination relates to an additional amount paid by the acquirer to the shareholders of the acquiree when certain conditions (such as meeting futures earnings targets) are met. Under ASC 805-30-25-5 through 25-7, the acquisition method requires that the contingency be measured at fair value and a liability be recorded at the closing date. Subsequent changes in fair value of contingent consideration are recorded in earnings.

Estimated liability needs to be recorded when a company offers customers something free or for a minimal charge to increase product sales. The customer may be required to provide proof of purchase to get the free product. Sometimes a nominal cash payment is also required.

EXAMPLE

XYZ Company includes a coupon in each cereal box that it sells. Customers may redeem 10 coupons and $5.00 in exchange for a toy that costs XYZ Company $10.00. Approximately 70% of the coupons are expected to be redeemed. This promotion began on December 1, 2X13 and the company sold 200,000 boxes of cereal. As of December 31, 2X13, no coupons had been redeemed. The estimated liability for coupons is calculated as follows:

Total coupons issued	200,000
Percentage expected to be redeemed	70%
Coupons expected to be redeemed	140,000
Number of coupons per toy	10
Number of toys to be distributed	14,000
Liability per toy	$ 5
Total liability for coupons	$70,000

EXAMPLE

In December 2X13, Mavis Company started to include one coupon in each box of popcorn. A customer will receive as a promotion a toy if 10 coupons and $1 are received. The toy costs $2.50. It is expected that 80% of the coupons will be exchanged. During December, 200,000 boxes of popcorn were sold, with no coupons being redeemed yet because the promotion just started. At year-end 2X13, the estimated liability for coupons is computed as follows:

Total coupons issued	200,000
Percentage of coupons expected to be redeemed	× 80%
To be redeemed	160,000
Number of toys to be distributed: 160,000/10 coupons =	16,000
Estimated liability for coupons—12/31/2X13:	
16,000 × $1.50* =	$24,000

*The liability is $2.50 cost per each toy less $1 to be received, or $1.50 per toy.

Exhibit 1 shows an accrual recorded for a loss contingency, from the annual report of Quaker State Oil Refining Company.

EXHIBIT 1: DISCLOSURE OF ACCRUAL FOR LOSS CONTINGENCY

Quaker State Oil Refining Company

Note 5: Contingencies. During the period from November 13 to December 23, a change in an additive component purchased from one of its suppliers caused certain oil refined and shipped to fail to meet the Company's low-temperature performance requirements. The Company has recalled this product and has arranged for reimbursement to its customers and the ultimate consumers of all costs associated with the product. Estimated cost of the recall program, net of estimated third party reimbursement, in the amount of $3,500,000 has been charged to current operations.

Exhibit 2 lists examples of loss contingencies and the general accounting treatment accorded them.

EXHIBIT 2: ACCOUNTING TREATMENT OF LOSS CONTINGENCIES

Accounting Treatment	Loss Related to:
Usually Accrued	1. Collectibility of receivables 2. Obligations related to product warranties and product defects 3. Premiums offered to customers
Not Accrued	1. Risk of loss or damage of enterprise property by fire, explosion, or other hazards 2. General or unspecified business risks 3. Risk of loss from catastrophes assumed by property and casualty insurance companies, including reinsurance companies
*May Be Accrued**	1. Threat of expropriation of assets 2. Pending or threatened litigation 3. Actual or possible claims and assessments** 4. Guarantees of indebtedness of others 5. Obligations of commercial banks under "standby letters of credit" 6. Agreements to repurchase receivables (or the related property) that have been sold

*Should be accrued when both criteria—probable and reasonably estimable—are met.

**Estimated amounts of losses incurred prior to the balance sheet date but settled subsequently should be accrued as of the balance sheet date.

A typical example of the wording of a disclosure regarding litigation is the note to the financial statements of Apple Computer, Inc., relating to its litigation concerning repetitive stress injuries, as shown in Exhibit 3.

EXHIBIT 3: ACCOUNTING TREATMENT OF LOSS CONTINGENCIES

Apple Computer, Inc.

"Repetitive Stress Injury" Litigation. The Company is named in numerous lawsuits (fewer than 100) alleging that the plaintiff incurred so-called "repetitive stress injury" to the upper extremities as a result of using keyboards and/or mouse input devices sold by the Company. On October 4, in a trial of one of these cases *(Dorsey v. Apple)* in the United States District Court for the Eastern District of New York, the jury rendered a verdict in favor of the Company, and final judgment in favor of the Company has been entered. The other cases are in various stages of pretrial activity. These suits are similar to those filed against other major suppliers of personal computers. Ultimate resolution of the litigation against the Company may depend on progress in resolving this type of litigation in the industry overall.

Risks and Uncertainties

The AICPA's Accounting Standard Executive Committee issued ASC 270-10-05, *Interim Reporting: Overall*. It requires disclosure of risks involving the nature of operations, use of estimates, and business vulnerability. With regard to the nature of operations, disclosure should be made of the company's major products and services, including by geographic locations. The relative importance of operations in multiple markets should also be discussed. Disclosure should be made of estimated accounts on which estimates are sensitive to near-term changes, such as technological obsolescence. Disclosure of corporate vulnerability to concentrations includes lack of diversification (e.g., customer base, suppliers, lenders, geographic areas, government contracts). An entity whose revenue is concentrated in certain products or services must make disclosure. Disclosure of information about significant concentrations of credit risk is also required for all financial instruments. Disclosure is mandated when concentrations exist for labor, supplies, materials, or other services which are necessary for an enterprise's operations. Overreliance on licenses and other rights should be noted.

Disclosure is required when a change in estimate would have a material effect on the financial statements. Examples of items requiring disclosure according to ASC 275-10-50-15 include:

- Rapid technological obsolescence of assets.

- Inventory subject to perishability, changing fashions, and styles.
- Capitalization of certain costs, such as for computer software or motion picture production.
- Insurance companies' deferred policy acquisition costs.
- Litigation-related liabilities and contingencies due to obligations of other enterprises.
- Valuation allowances for commercial and real estate loans, and allowances for deferred tax assets.
- Amounts of long-term obligations, such as for pension obligations and other benefits.
- Amounts of long-term contracts.
- Proceeds or expected loss on disposition of assets.
- Nature and amount of guarantees.

When an entity is vulnerable to concentration-related risks, disclosure is required if the concentration existed at the date of financial statements, the entity may suffer significantly because of the concentration risk, and it is reasonably possible that concentration-risk-related events will occur in the near future.

Uncertainties with labor unions should be noted. For organizations with significant concentrations of labor subject to collective bargaining agreements, the disclosure should include:

- The percentage of the labor force covered by a collective bargaining agreement.
- The percentage of the labor force covered by a collective bargaining agreement where the agreement will expire within one year.

Compensated Absences

ASC 710-10-15-3, *Compensation—General: Overall*, states that compensated absences include sick leave, vacation time, and holidays. The pronouncement also applies to sabbatical leaves related to past services rendered. The pronouncement does not apply to deferred compensation, postretirement benefits, severance (termination) pay, stock option plans, and other long-term fringe benefits (e.g., disability, insurance).

An estimated liability based on current salary rates should be accrued for compensated absences when all of the following criteria are satisfied:

(a) Employee services have been **rendered.**

(b) Employee rights have **vested**, meaning the employer is obligated to pay the employee even though he or she leaves the employment voluntarily or involuntarily.

(c) **Probable** payment exists.

(d) The amount of estimated liability can be **reasonably determined.**

If the conditions are met but the amount cannot be determined, no accrual can be made. However, there should be footnote disclosure.

Accrual for sick leave is required only when the employer allows employees to take accumulated sick leave days off regardless of actual illness. No accrual is made if workers may take accumulated days off only for actual illness, because losses for these are usually insignificant in amount. An employer should not accrue a liability for nonvesting rights for compensated absences expiring at the end of the year they are earned, because no accumulation is involved. However, if unused rights do accumulate, a liability should be accrued.

EXAMPLE

Estimated compensation for future absences is $40,000. The journal entry is:

Expense	40,000	
Estimated liability		40,000

If, at a later date, a payment of $35,000 is required, the journal entry is:

Estimated liability	35,000	
Cash		35,000

EXAMPLE

Blumenfrucht Corporation has a plan for compensated absences providing workers with 8 and 12 paid vacation and sick days, respectively, that may be carried over to future years. Instead of taking their vacation pay, the workers may select payment. However, no payment is allowed for sick days not taken. At year-end X13, the unadjusted balance of the liability for compensated absences was $34,000. At year-end 2X13, it is estimated that there are 110 vacation days and 80 sick leave days available. The average per-day pay is $125. On December 31, 2X13, the liability for compensated absences is $13,750 ($125 per day × 10 days). There is no accrual for unpaid sick days because payment of the compensation is not probable.

ASC 710-10-25-4, *Compensation—General: Overall*, states that compensation costs applicable to an employee's right to a sabbatical or other similar arrangement should be accrued over the mandatory service years.

Exhibit 4 shows an example of an accrual for compensated absences.

EXHIBIT 4: BALANCE SHEET PRESENTATION OF ACCRUAL

FOR COMPENSATED ABSENCES

Current liabilities	
Accounts payable	$ 6,308
Accrued salaries, wages and commissions	2,278
Compensated absences	2,271
Accrued pension liabilities	1,023
Other accrued liabilities	4,572
	$16,452

If an employer meets conditions (a), (b), and (c) but does not accrue a liability because of a failure to meet condition (d), it should disclose that fact. Exhibit 5 shows an example of such a disclosure, in a note from the financial statements of Gotham Utility Company.

EXHIBIT 5: DISCLOSURE OF POLICY FOR COMPENSATED ABSENCES

Gotham Utility Company

Employees of the Company are entitled to paid vacation, personal, and sick days off, depending on job status, length of service, and other factors. Due to numerous differing union contracts and other agreements with nonunion employees, it is impractical to estimate the amount of compensation for future absences, and, accordingly, no liability has been reported in the accompanying financial statements. The Company's policy is to recognize the cost of compensated absences when actually paid to employees; compensated absence payments to employees totaled $2,786,000.

Deferred Compensation Agreement

An accrual should be made over the service years of active employees for deferred compensation starting with the agreement date. Examples of deferred compensation agreements are a covenant not to compete, continued employment for a specified period, and availability to render services after retirement. The total amount accrued at the end of the employee's service years should at least equal the discounted value of future payments to be made. The annual journal entry to record deferred compensation is:

Deferred compensation expense	XXX	
Deferred compensation liability		XXX

Accounting For Special Termination Benefits (Early Retirement)

An accrual of a liability for employee termination benefits in the period that management approves the termination benefit package is required if the following circumstances are met:

- The benefits that terminated employees will receive have been agreed on and have been accepted by management prior to the financial statement date.
- Employees are made aware of the termination agreement prior to the issuance of the financial statements.
- The termination benefit plan provides the following data: (a) the number of employees to be terminated, (b) their job categories, and (c) the location of their jobs.
- Significant changes to the plan are not likely, so that completion of the plan may be expected in a short time.

The termination plan may include both individuals who have been involuntarily terminated and those who have voluntarily decided to leave their current employ. The latter may have been coaxed into leaving with the promise of higher termination benefits. The accrued liability should be based on the number of employees who will be terminated and the benefits that will be paid to both involuntarily and voluntarily terminated employees. The amount of the accrual equals the down payment plus the present value discounted of future payments.

When it can be objectively measured, the impact of changes on the employer's previously accrued expenses related to other employee benefits directly associated with employee termination should be included in measuring termination expense.

EXAMPLE

On January 1, 2X13, an incentive is offered for early retirement. Employees are to receive a payment of $100,000 today, plus payments of $20,000 for each of the next 10 years. Assume a discount rate of 10%. The journal entry is:

Expense	222,900	
Estimated liability		222,900
Down payment		$100,000
Present value of future payments ($20,000 × 6.145)*		122,900
Total		$222,900

*Present value factor for n = 10, i = 10% is 6.145. (Table 2 in the Appendix)

Troubled Debt

Frequently, during depressed economic times, debtors may be unable to pay their creditors. Because of the debtor's financial difficulties, it may be necessary for a creditor to grant a concession that otherwise would not have been considered. The accounting of debtors and creditors for troubled debt is based on the guidance of two FASB statements:

- ASC 310-40 and 470-60, *Receivables: Troubled Debt Restructurings by Creditors*.
- ASC 310-10-35-1 and 35-53, *Receivables: Overall*.

The latter statement modifies the former with respect to accounting by a creditor for modification of loan terms. When a troubled loan materializes, the creditor is required first to recognize a loss on impairment of the debt. After this, either the terms of the loan are modified or the loan is settled on terms that are not favorable to the creditor.

The concept of impairment of loans will be discussed first, followed by the restructuring of troubled debt.

Accounting by Creditors for Impairment of a Loan

ASC 310-10-35-1 and 35-53 requires that impairment of a loan by a creditor be recognized when it is probable that a creditor will be unable to collect all that is contractually owed, including both principal and interest. A loan, for example, that is modified in a troubled debt restructuring is considered impaired. A temporary delay of payment, however, is not considered an impairment. In addition, a loan should not be considered impaired if the creditor expects to collect all amounts that are due including any accrued interest for any delay in payment that may have occurred.

When a loan is classified as being impaired, measurement of the impairment is based on the expected new future cash flows discounted using the original historical contractual rate, not the rate specified in the restructuring agreement. If, on the other hand, the loan is collateralized or has a market price, the amount of impairment may be measured with the assistance of those amounts. For example, if foreclosure is probable, the impairment of the loan may be based on the fair market value of the collateral. The difference between the book value of the impaired loan and the amount of impairment should be recorded by debiting the bad debts expense account with a corresponding credit to a valuation allowance account. If a change occurs in the amount or timing of the new expected cash flow

subsequent to the measurement of impairment, the creditor should recalculate the amount of impairment and adjust the valuation account in the period in which this change becomes known.

When the impairment is recognized using the present value of new expected cash flows, the creditor should recognize interest income using the effective interest method. Any changes in the initial impairment resulting from changes in the amount or timing of cash flows should be recorded as an entry in the bad debt expense, and allowance valuation accounts. This includes any changes that are based on the modifications of the market value of the loan or its collateral.

Disclosure should be made, as of the balance sheet date, of the recorded investment in loans for which impairment has been recognized less the allowance for related loan losses. In addition, each period for which an income statement is presented, an analysis should be disclosed of any changes in the valuation allowance account. The creditor's income recognition policy with respect to loan impairment should also be shown.

EXAMPLE

On January 1, 2X10, X Financing Company loaned $1,000,000 to Y Company. The loan was issued in the form of a 6-year zero-interest-bearing note due on December 31, 2X15, generating an effective yield of 8%. As a result, Y Company was paid proceeds of $630,170 This amount was computed in the following way:

$1,000,000 × present value of $1 discounted for 6 years at 8% (Table 1 in the Appendix)
= $1,000,000 × .63017
= $630,170

The following entry would be made on January 1, 2X10, by the creditor, X Financing Company, when the note was accepted and the proceeds issued to the Y Company, the debtor:

Notes receivable	1,000,000	
Discount on notes receivable		369,830
Cash		630,170

The following table shows the amortization of the discount on the note by X Financing Company over the life of the note.

Date	***Interest Revenue (8%)***	***Discount Amortized***	***Carrying Value of the Note***
1/1/2X10			$ 630,170

12/31/2X10	$50,414*	$50,414	680,584
12/31/2X11	54,447	54,447	735,031
12/31/2X12	58,802	58,802	793,833
12/31/2X13	63,507	63,507	857,340
12/31/2X14	68,587	68,587	925,927
12/31/2X15	74,073**	74,073	1,000,000

*$630, 170 × 8%

**Understated by $1 due to rounding.

On December 31, 2X13, because of a downturn in the economy and depression in the industry of Y Company, X Financing Company, after a comprehensive review of all available evidence at its disposal, determined that it was probable that Y Company would pay back only $400,000 of the loan at maturity. These facts indicated to X Financing Company that the loan was impaired and that a loss should be recorded immediately.

ASC 310-10-35-1 and 35-53 requires that X Financing Company compute the present value of the new expected cash flows at the original contractual effective rate of interest. Based on present value calculations, this amount is $342,936, computed in the following way:

$4,000,000 × present value of $1 discounted for 2 years at 8%
= $4,000,000 × .85734
= $342,936

The impairment loss is the difference between the recorded value of the loan and the new expected present value of future cash flows from it. The impairment loss to X Financing Company is calculated as follows:

Carrying value of loan to creditor at Dec. 31, 2X13	$857,340
Less: present value of new expected cash flows of $400,000 discounted for 2 years at 8%	342,936
Impairment loss to X Financing Company	$514,404

The entry to record the impairment of the loan on the accounting records of X Financing is:

Bad debts expense	514,404	
Allowance for impairment of note		514,404

No entry is made on the accounting records of the debtor entity, Y Company, for the impairment of the loan.

Troubled Debt Restructuring

ASC 310-40 and 470-60 states that in a troubled debt situation the debtor is having significant financial problems and receives partial or full relief of the debt by the creditor. The relief may be in the form of any of the following:

- Creditor/debtor agreement.
- Repossession or foreclosure.
- Relief dictated by law.

The types of troubled debt restructuring include:

- Debtor transfers to creditor receivables from third parties or other assets in part or in full satisfaction of the obligation.
- Debtor transfers to creditor stock to satisfy the debt.
- Modification of debt terms, such as through extending the maturity date, reducing the balance due, or reducing the interest rate.

In restructuring, an extraordinary gain is recognized by the debtor, but either an ordinary or extraordinary loss is recognized by the creditor, depending on how unusual or infrequent the occurrence is. In most cases, it is an ordinary loss.

The extraordinary gain of the debtor equals the difference between the fair market value of the assets exchanged and the book value of the debt, including accrued interest. In addition, there may arise a gain on the disposal of the assets exchanged equal to the difference between the fair market value and the book value of the transferred assets. This gain or loss is not from the restructuring but instead an ordinary gain or loss arising from asset disposal.

EXAMPLE

A debtor transferred assets having a fair market value of $7,000 and a book value of $5,000 to satisfy a debt with a carrying value of $8,000. The gain on restructuring is $1,000 ($8,000 - $7,000), and the ordinary gain is $2,000 ($7,000 - $5,000).

If a debtor transfers an equity interest to the creditor, the debtor records the stock issued at its fair market value, not the recorded value of the debt relieved. The difference between these values is recorded as an extraordinary gain.

Any adjustment in the terms of the initial obligation is accounted for prospectively. A new interest rate is computed based on the new terms. The interest rate is then used to allocate future payments as a reduction in principal and interest. When the new terms of the agreement result in the total future payments being less than the book value of the debt, the debt is reduced, with a restructuring gain being recorded for the difference. ASC 310-40 and 470-60 requires that the gain on restructuring be based on the undiscounted restructured cash flows. Future payments are considered a reduction of principal only. Interest expense is not recognized.

There may be a mix of concessions offered to the debtor. This may arise when assets or equity are transferred for part satisfaction of the debt, with the balance subject to the modification of the terms. The two steps are:

1. Reduce the debt by the fair market value of the asset or equity transferred.
2. The balance of the debt is treated as an adjustment of the terms for accounting purposes.

Any direct costs (e.g., attorney fees) incurred by the debtor in the equity transfer reduce the fair market value of the equity interest. Any other costs reduce the gain on restructuring. If no gain is involved, direct costs are expensed.

Footnote disclosure by the debtor should be made of the terms surrounding the restructuring, gain on restructuring in aggregate and per-share amounts, and contingently payable amounts and terms.

The creditor's loss is the difference between the fair market value of assets received and the carrying value of the investment. When credit terms are modified, the following occurs:

- ASC 310-10-35-1 and 35-53 requires that the creditor's loss be based on the new expected cash flows discounted at the original contractual effective interest rate. The FASB believes that because loans are recorded initially at discounted amounts, the ongoing assessment for impairment should be made in a similar manner. (The debtor's gain on restructuring, as was previously noted, should be based on undiscounted amounts as required by ASC 310-40 and 470-60.)
- Direct costs are immediately expensed.
- Assets are recorded at fair market value.
- Interest revenue is recorded for the excess of total future payments over the carrying value of the receivable. Interest revenue is determined using the effective interest method.

- An ordinary loss is recognized for the difference between the carrying value of the receivable and the total payments.
- Any cash received in the future is treated as investment recovery.

The creditor does not recognize contingent interest until the contingency no longer exists and interest has been earned.

Any change in interest rates is treated as a change in estimate.

The following should be footnoted:

- Description of restructuring provisions (e.g., time period, interest rate).
- Outstanding commitments.
- Receivables by major category.

EXAMPLE

The debtor owes the creditor $80,000 and, owing to financial difficulties, may be unable to make future payments. Footnote disclosure is required.

EXAMPLE

The debtor owes the creditor $70,000. The creditor relieves the debtor of $10,000, with the balance payable at a future date. The journal entries follow:

Debtor		
Accounts payable	10,000	
Extraordinary gain		10,000
Creditor		
Ordinary loss	10,000	
Accounts receivable		10,000

EXAMPLE

The debtor owes the creditor $90,000. The creditor commits to accept a 30% payment in full satisfaction of the obligation. The journal entries are:

Debtor		
Accounts payable	63,000	

Extraordinary gain		63,000
Creditor		
Ordinary loss	63,000	
Accounts receivable		63,000

EXAMPLE

The following information applies to the transfer of property arising from a troubled debt restructuring:

Book value of liability liquidated	$300,000
Fair market value of property transferred	170,000
Book value of property transferred	210,000
The extraordinary gain on restructuring equals:	
Book value of liability liquidated	$300,000
Less: fair market value of property transferred	170,000
Extraordinary gain	$130,000
The ordinary gain (loss) on the transfer of the property equals:	
Book value of property transferred	$210,000
Fair market value of property transferred	170,000
Ordinary loss	$ 40,000

Impairment of Loans

ASC 310-10-35-1 through 35-53 and 310-10-50-1 through 50-26, apply to the accounting, reporting, and disclosures by a creditor for the impairment of a loan. They require creditors to determine the impaired value of a loan typically based on the discounted value of expected net cash flows associated with the loan. In addition to accounting for ensuing losses, appropriate footnote disclosure should be made. A number of methods may be used to determine how much impairment has occurred, including:

- Present value of anticipated future cash flows discounted at the loan's effective interest rate.
- The loan's market price.
- The face value of the collateral (assuming probable foreclosure).

The creditor records the impaired value of the loan as a debit to bad debts expense and a credit to the valuation allowance.

The creditor may recognize income on an impaired loan using the cost recovery method, cash basis method, or a combination.

The creditor should disclose, either in the body or footnotes to the financial statements, the following:

- Total investment in impaired loans along with valuation allowances.
- Method used and interest revenue recorded on impaired loans.
- Credit losses incurred.

Refinancing Short-Term Debt to Long-Term Debt

According to ASC 470-10-45-12A, *Debt: Overall*, a short-term debt should be reclassified as a long-term debt when either of the following conditions apply:

1. After year-end but before the audit report date, the short-term debt is rolled over into a long-term debt, or an equity security is issued in substitution.

2. Before the audit report date, the company contracts to refinance the current debt on a long-term basis and all of the following conditions are satisfied:

    a. Agreement is for a period of one year or more.

    b. No provision of the agreement has been violated.

    c. The parties are financially sound and therefore able to satisfy all of the requirements of the agreement.

When debt is reclassified from short term to long term because of conditions described in item 1, it should be classified under long-term liabilities, not stockholders' equity, even if equity securities were subsequently issued in substitution of the debt.

If short-term debt is excluded from current liabilities, the amount of short-term debt excluded from current liabilities should be the minimum amount expected to be refinanced based on conservatism.

Caution: The exclusion from current liabilities cannot exceed the net proceeds of debt or security issuances, or amounts available under the refinancing agreement. The latter amount must be adjusted for any restrictions in the contract that limit the amount available to pay off the short-term debt. If a reasonable estimate is not ascertainable from the agreement, the full amount must be classified as current debt. Further, a refinancing intent may be absent if the contractual provisions permit the lender or investor to establish unrealistic interest rates, security, or other related terms.

The refinancing of one short-term obligation with another is not sufficient to demonstrate the ability to refinance on a long-term basis.

ASC 470-10-55-1, *Debt: Overall*, stipulates that if cash is paid for the short-term debt, even if long-term debt of a similar amount is issued the next day, the short-term debt should be presented under current liabilities because cash was paid.

Footnote disclosure is required of the amount excluded from current liabilities. Disclosure is also mandated for the contractual terms and any noncurrent debt or equity securities issued or expected to be issued in substitution of the short-term debt.

Callable Obligations by the Creditor

ASC 470-10-45-11, *Debt: Overall*, deals with long-term debt callable or payable on demand by the creditor. If the debtor violates the debt agreement, and the long-term obligation therefore becomes callable, the debt must be included as a current liability, except if one of the following conditions exists:

- The creditor waives or loses his or her right to require repayment for a period exceeding one year from the balance sheet date. Refer to ASC 470-10-45 and 55.
- There exists a grace period under which it is probable that the debtor will cure the violation.

ASC 470-10-50-3, *Debt: Overall*, defines a subjective acceleration clause as one allowing the lender unilaterally to accelerate all or part of a noncurrent debt. For example, the lender in its sole discretion may accelerate repayment of the debt if it is believed that the borrower is experiencing significant profitability or cash difficulties. If it is probable that the acceleration provision will be enforced by the lender, the amount of the noncurrent debt likely to be accelerated should be classified as a current liability by the debtor. However, if acceleration by the lender is only reasonably possible, footnote disclosure is sufficient. If a remote possibility exists as to acceleration, no disclosure is needed.

An objective acceleration clause in a long-term debt agreement includes objective criteria to assess calling all or part of the debt. Examples are setting forth a minimum cash position or a minimum current ratio. If there is a violation of an objective acceleration provision, most noncurrent debts become callable immediately by the lender, or are callable after some predetermined grace period. In such cases, the creditor may demand repayment of all or part of the debt due as per the contract.

Footnote disclosure is required for the reasons and circumstances surrounding callable obligations and their balance sheet classification. Subsequent event disclosure is required when the violation occurs after year-end but before the audit report date.

Other reference sources are ASC 470-10-45-9 and 45-10, and ASC 470-10-45-3 through 45-6.

Inducement Offer to Convert Debt to Equity

The holder of the convertible debt has an option to receive (1) the face or redemption amount of the security or (2) common shares. The debt and equity elements of convertible debt are inseparable. The entire proceeds should be accounted for as debt until conversion.

ASC 470-20-05-10, *Debt: Debt with Conversion and Other Options*, states if convertible debt is converted into stock because of an inducement offer in which the debtor changes the conversion privileges (e.g., conversion ratio, issuance of warrants, or cash compensation), the debtor must record the inducement as an expense of the current period. However, it is not an extraordinary item. The conversion expense equals the fair market value of the securities and other consideration transferred in excess of the fair market value of the securities issuable based on the original conversion term. It is measured at the date the inducement offer is accepted by the convertible bondholders (usually the conversion or agreement date). The FASB views the inducement given as a compensatory payment to convertible bondholders for converting their securities to stock. If the additional inducement comprises stock, the market value of the stock is credited to common stock at par value, with the excess over par credited to paid-in-capital and with the offsetting-debit-to-debt conversion expense. If the additional inducement is assets, the market value of the assets is credited with an offsetting-charge-to-debt conversion expense. For example, the inducement may be in the form of cash or property. ASC 470-20-05-10 applies only to induced conversions that may be exercised for a limited time period.

EXAMPLE

On April 1, 2X10, a company issued $500,000 8% bonds at face value. Each $1,000 bond is convertible into 15 shares of common stock having a par value of $30. On July 1, 2X13, the company offers to increase the conversion rate to 18 shares per $1,000 bond to induce conversion through this “sweetener.” The debtholders accept this offer. At this date, the market value of the stock is $50 per share. Therefore, the additional consideration given as an inducement to the holders of the $500,000 bonds will be $75,000, computed as follows:

($500,000/$1,000) = 500 bonds

500 bonds × 3 shares per $1,000 band = 1500 shares

Fair market value of additional consideration equals

1500 shares × $ 50 = 75,000

The journal entry for the conversion is:

Bonds payable	500,000	
Debt conversion expense	75,000	
Common stock (9,000 shares* × $30)		270,000
Paid-in-capital		305,000

* 500 bonds × 18 shares per bond = 9,000 shares

EXAMPLE

A company has outstanding $400,000 of convertible bonds issued at par value. Each $1,000 bond is convertible into 12 shares of $20 par value common stock. To induce bondholders to convert, the company increased the conversion rate from 12 shares per $1,000 bond to 16 shares per $1,000 bond. When the market price of the stock was $25, one bondholder converted his $1,000 bond. The amount of incremental consideration is $100 (4 additional shares × $25). The journal entry is:

Bonds payable	1,000	
Debt conversion expense	100	
Common stock (16 shares × $20)		320
Paid-in-capital		780

EXAMPLE

A bondholder is holding a $10,000 face value convertible bond that was issued at par. Each $1,000 bond is convertible into 50 shares of stock having a par value of $12. To induce conversion, the company offers the bondholder land having a fair market value of $1,500 at the date of conversion. The cost of the land is $1,200. The journal entries associated with the induced conversion are:

Land	300	
Gain		300

To increase land to fair value to use as inducement:

Bonds payable	10,000	
Debt conversion expense	1,500	
Land		1,500
Common stock (500* shares × $12)		6,000
Paid-in-capital		4,000

*$10,000/$1,000 = 10 bonds.

10 bonds × 50 shares = 500 shares.

If the debtor places cash or other assets in an irrevocable trust to be used only to pay interest and principal on the obligation, disclosure is required of the particulars concerning the transaction and the amount of debt considered extinguished.

ASC 470-20-30-27 and 30-28, states that interest costs associated with convertible debt instruments recognized in periods subsequent to their initial recognition should constitute the borrowing rate a company would have incurred had it issued a comparable debt instrument without the embedded conversion option. That objective is achieved by requiring issuers to separately account for the liability and equity components of convertible debt instruments.

The following steps should be used to *initially* measure the convertible debt:

1. Determine the carrying value of an instrument's liability component using a fair value measurement of a similar liability (including embedded features, if any, other than the conversion option) that has no related equity component.

2. Determine the carrying value of the instrument's equity component corresponding to the embedded conversion option by subtracting the liability component's fair value from the initial proceeds applicable to the total convertible debt instrument.

Appraise the total convertible debt instrument if its embedded features, other than the conversion option, are substantive at the issuance date. If, at issuance, the company concludes that it is *probable* that a convertible instrument's embedded feature will not be exercised, that embedded feature is considered to be nonsubstantive and would not impact the initial measurement of an instrument's liability component.

Transaction costs incurred with third parties except the investors that directly relate to convertible debt issuance should be allocated to the liability and equity components in the same proportion as the allocation of proceeds and accounted for as costs of issuing debt and equity, respectively.

A temporary tax basis difference associated with the liability component may occur. Additional paid-in-capital should be adjusted when deferred taxes are initially recognized for the tax impact of the temporary difference.

The principal amount of the liability component over its initial fair value must be amortized to interest cost using the interest method.

A liability component's anticipated life is not impacted by embedded features determined to be nonsubstantive when the convertible debt was issued.

If a conversion option has to be reclassified from stockholders' equity to a liability measured at fair value, the difference between the amount that has been recognized in equity and the fair value of the

conversion option at the date of reclassification should be accounted for as an adjustment to stockholders' equity. On the other hand, when a conversion option accounted for in stockholders' equity is reclassified as a liability, gains or losses recognized to account for that conversion option at fair value while classified as a liability should not be reversed if later the conversion option is reclassified back to stockholders' equity. The reclassification of a conversion option does not impact the accounting for the liability component.

The following should be disclosed:

- Conversion price and the number of shares used to calculate the total consideration to be delivered on conversion.
- Effective interest rate on the liability component.
- Amount of interest cost applicable to both the contractual interest coupon and discount amortization on the liability component.
- Carrying value of the equity component.
- Principal amount of the liability component, its amortized discount, and its carrying value.
- Remaining years for which the discount on the liability will be amortized.
- Amount by which the instrument's if-converted value is more than the principal amount, irrespective of whether the instrument is currently convertible.
- Term of derivative transactions, reasons to enter into derivative transactions, and number of shares underlying derivative transactions.

Accounting Standards Update (ASU) No. 2009-15 (ASC 470, *Debt*), *Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing*, which is based on EITF Issue No. 09-1, provides information on the following:

- Provides accounting and reporting advice for bonds and other types of preferred stock with conversion attributes. These include convertible bonds, bonds with detachable warrants, forfeiture of interest, and conversions that are induced. (ASC 470-20-05-1)

- Is applicable in the following instance. A firm that has a high cost of borrowed shares may contract for share lending separately transacted but along with a convertible bond issuance. The share lending contract allows investors to hedge the conversion option. (ASC 470-20-05-12A)

- Provides guidance when, in a share-lending contract, the firm issues loaned shares to an investment bank for a small charge. This fee typically equals the par value of the common stock, which is usually below the market value of the loaned securities. At maturity, the loaned shares are returned to the company. (ASC 470-20-05-12B)

- Offers guidance for properly recording a share-lending contract. When issued, a share-lending contract is recorded at market value and recorded at issuance cost with an adjustment to paid-in-capital. (ASC 470-20-25-20A)

Chapter 1 Review Questions

6. Which of the following is the correct way to report assets and liabilities on the balance sheet under the fair value option?

A. Use two separate line items for fair value and non-fair value carrying amounts.

B. Combine assets and liabilities on a net basis.

C. Create a separate fair value mezzanine section between current and long-term debt

D. Place assets and liabilities in the long-term assets and liabilities sections.

7. Vadis Co. sells appliances that include a 3-year warranty. Service calls under the warranty are performed by an independent mechanic under a contract with Vadis. Based on experience, warranty costs are estimated at $30 for each machine sold. When should Vadis recognize these warranty costs?

A. Evenly over the life of the warranty.

B. When the service calls are performed.

C. When payments are made to the mechanic.

D. When the machines are sold.

8. Which of the following statements characterizes convertible debt?

A. The holder of the debt must be repaid with shares of the issuer's stock.

B. No value is assigned to the conversion feature when convertible debt is issued.

C. The transaction should be recorded as the issuance of stock.

D. The issuer's stock price is less than market value when the debt is converted.

9. On January 3, Year 1, North Company issued long-term bonds due January 3, Year 6. The bond covenant includes a call provision that is effective if the firm's current ratio falls below 2:1. On June 30, Year 1, the fiscal year-end for the company, its current ratio was 1.5:1. The bonds should be reported on the financial statements as a

A. Long-term debt because their maturity date is January 3, Year 6.

B. Long-term debt if it is reasonably possible that North can cure the covenant violation before the end of any allowed grace period.

C. Current liability if the covenant violation is not cured.

D. Current liability, regardless of any action by the bondholder, because the company was in violation of the covenant on the balance sheet date.

Chapter 2:

Long-Term Liabilities

Learning Objectives:

After completing this chapter, you should be able to:

- Recognize the accounting valuation for bonds at date of issuance.
- Identify the methods of bond discount and premium amortization.
- Recognize the accounting procedures for long-term notes payable.

Bond Accounting

The yield on a bond may be calculated based on either the simple yield or yield to maturity (effective interest) methods:

Simple yield = Nominal interest/Present value of bond

$$\text{Yield to maturity} = \frac{\text{Nominal interest} + \text{Discount/Years (or - Premium/Years)}}{(\text{Present value} + \text{Maturity value})/2}$$

Simple yield is less accurate than yield to maturity.

EXAMPLE

A $300,000, 8%, 10-year bond is issued at 98%.

$$\text{Simple yield} = \frac{\text{Nominal interest}}{\text{Present value of bond}}$$

$$\frac{\$24{,}000}{\$294{,}000} = 8.16\%$$

$$\text{Yield to maturity} = \frac{\text{Nominal interest + Discount/Years}}{\text{(Present value + Maturity value/2)}}$$

$$\frac{\$24{,}000 + \$6{,}000/10}{(\$294{,}000 + \$300{,}000)/2} = 8.2\%$$

If a bond is sold at a discount, yield will exceed the nominal interest rate. However, if a bond is sold at a premium, yield will be less than the nominal interest rate.

A bond discount or premium may be amortized using either the **straight-line method** or the **effective-interest method** (scientific amortization). The latter method is preferred because it results in a better matching of periodic expense with revenue. Under the straight-line method, the amortization per period results in a fixed dollar amount but at a varying effective rate. Under the effective interest method, the amortization per period results in a constant rate of interest but a varying dollar amount.

The amortization entry under the effective-interest method is:

Interest expense (Yield × Carrying value of bond at the beginning of the year)
Discount (for balance)
Cash (nominal interest rate × face value of bond)

In the early years, using the effective-interest method results in a lower amortization amount relative to the straight-line method (either for discount or premium). The periodic amortization will increase if the bonds were issued at either a discount or a premium.

EXAMPLE

On January 1, 2X12, a $200,000 bond is issued at $194,554. The yield rate is 5% and the nominal interest rate is 4%. The effective-interest method is used. A schedule for the first two years follows:

Date	*Debit Interest Expense*	*Credit Cash*	*Credit Discount*	*Book Value*
1/1/2X12				$194,554
12/31/2X13	$9,727	$8,000	$1,727	196,281
12/31/2X14	9,814	8,000	1,814	198,095
12/31/2X15	9,905	8,000	1,905	200,000

Note: Interest expense is increasing because the carrying value of the bond is increasing.

On December 31, 2X13, the journal entry is:

Interest expense	9,727	
Cash		8,000
Discount		1,727

EXAMPLE

On January 1, 2X13, a company issued 10% bonds with a face value of $600,000 for $560,000 to yield 11%. Interest is payable semi-annually on January 1 and July 1. The effective interest method of amortization is used. The journal entries for 2X13 are:

1/1/2X13		
Cash	560,000	
Discount on bonds payable	40,000	
Bonds payable		600,000
7/1/2X13		
Interest expense		
(11% × $560,000 × 6/12)	30,800	

Cash (10% × $600,000 × 6/12)		30,000
Discount on bonds payable		800

The book value of the bonds on July 1, 2X13, after the preceding entry is as follows:

Bonds payable	$600,000	
Less: discount on bonds payable ($40,000 - $800)	39,200	
Book value	$560,800	
12/31/2X13		
Interest expense (11% × $560,800 × 6/12)	30,844	
Cash (10% × $600,000 × 6/12)		30,000
Discount on bonds payable		844

EXAMPLE

Cohen Company has outstanding an 8%, 10-year, $200,000 bond. The bond was initially issued to yield 7%. Amortization is based on the effective interest method. On July 1, 2X12, the carrying value of the bond was $211,943. The unamortized premium on the bond on July 1, 2X13, was $10,779 computed as follows:

Unamortized premium—7/1/2X12		
($211,943 - $200,000)		$11,943
Less: amortized premium for the year-ended 7/1/2X13:		
Nominal interest ($200,000 × 8%)	$16,000	
Effective interest ($211,943 × 7%)	14,836	1,164
Unamortized premium—7/1/2X13		$10,779

Bonds payable may be issued between interest dates at a premium or discount. If a bond is issued between interest dates, the journal entry is:

Cash
Discount (or credit premium)
Bonds payable
Interest expense

EXAMPLE

On April 1, 2X12, a $500,000, 8% bond with a five-year life dated 1/1/2X12, is issued at 106%. Interest is payable on 1/1 and 7/1. The company uses the straight-line amortization method. The journal entries are:

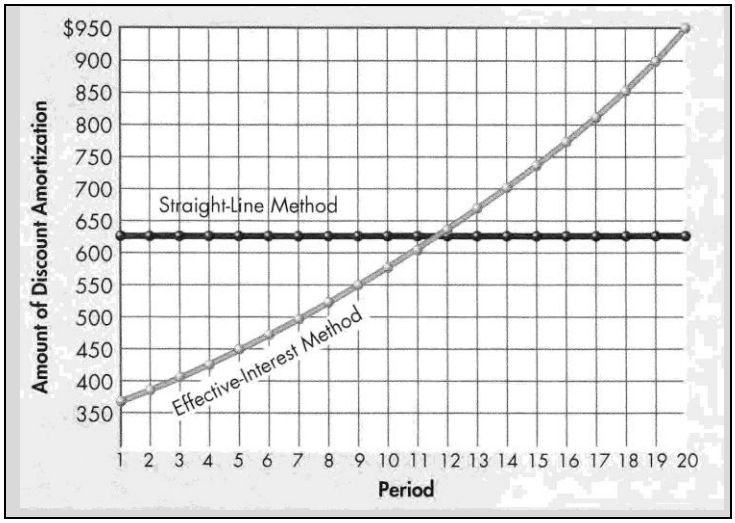
4/1/2X12		
Cash ($530,000 + $10,000)		540,000
Bonds payable		500,000
Premium on bonds payable ($500,000 × 6%)		30,000
Interest expense ($500,000 × 8% × 3/12)		10,000
7/1/2X12		
Interest expense	20,000	
Cash		20,000
Premium on bonds payable	1,578	
Interest expense		1,578

4/1/2X12 - 1/1/2X17 = 4 years, 9 months = 57 months $30,000/57 = $526 per month (rounded)
4/1/2X12 - 7/1/2X12 = 3 months
3 months × $526 = $1,578

12/31/2X12		
Interest expense	20,000	
Interest payable		20,000
Premium on bonds payable	3,156	
Interest expense		3,156
(6 months × $526 = $3,156)		
1/1/2X13		
Interest payable	20,000	
Cash		20,000

Exhibit 6 presents the comparison of straight-line and effective-interest amortization methods.

EXHIBIT 6: COMPARISON OF STRAIGHT-LINE AND EFFECTIVE-INTEREST AMORTIZATION METHODS



Bonds Payable is presented in the balance sheet at its book value in the following manner:

Bonds payable
Add: premium on bonds payable
Less: discount on bonds payable
Carrying value

Bond issue costs are the expenditures incurred in issuing bonds, such as legal, accounting, underwriting, commissions, registration, engraving, and printing fees. Bond issue costs should preferably be deferred and amortized over the life of the bond. They are presented as a deferred charge. However, two alternative acceptable methods exist to account for bond issue costs: to expense such costs immediately or to treat them as a reduction of bonds payable.

Serial bonds (bonds maturing in installments) may be issued as if each series were a separate bond issue or as one issue having varying maturity dates. In most cases, each series has the same interest rate and yield but different issue prices, depending upon their maturity period. One discount or premium account exists for all the bonds in the series. The effective- interest method is used in determining amortization of the discount or premium.

The price of a bond is calculated as follows:

- The face value is discounted using the present value of $1 table (Table 1 in the Appendix).

- Interest payments are discounted using the present value of ordinary annuity of $1 table. (Table 2 in the Appendix)
- Yield is used as the discount rate.

EXAMPLE

A $100,000 10-year bond is issued at an 8% nominal interest rate. Interest is payable semiannually. The yield rate is 10%. The present value of $1 table factor for n = 20, i = 5% is 12.46221. The price of the bond is

Present value of principal $100,000P × .37689	$37,689
Present value of interest payments $4,000 × 12.46221	49,849
Present value	$87,538

The issuance of convertible bonds usually allows the company to issue the securities at a lower interest rate with fewer restrictions compared to a conventional bond. When issued, the face value of the convertible bond usually will be more than the market value of the stock into which it is convertible. Further, at issuance no value is assigned to the conversion feature. The sale is only recorded as the issuance of debt. The conversion price is typically set at about 15% more than the market price of the stock when the convertible bond is issued. Unless attributable to antidilution, the conversion price remains the same. There may be a call feature allowing the issuer to call the bonds back before maturity. As the value of the stock increases, so does the value of the convertible bond. When the market value of the shares associated with the convertible bond exceeds the face value of the debt, the holder will benefit by converting the debt into shares. Alternatively, in such a situation the issuer may force conversion. If the market price of the stock remains the same or goes down, the holder of the convertible bond will not convert it into the stock. This is referred to as an overhanging bond. In other words, a holder will not convert if the market value of the common stock is less than the face value of the convertible bond. When this occurs, the issuer has a number of options, such as exercising the call feature and paying the bondholders the face amount of the bond, providing an inducement in the form of additional consideration to convert, or waiting until maturity to pay the principal of the debt. In bankruptcy, the convertible bond is subordinate to nonconvertible debt.

The strongly preferred and widely used method to account for the conversion of a bond into stock is the book value of bond method. A drawback to the *book-value method* is that it fails to recognize in the accounting for the conversion the total value of the equity security issued. Although much less desirable, in a few exceptional cases when justified, the market value of bond or market value of stock method might be used.

Note: The market-value method is rarely used in practice and may be precluded under ASC 470-50-05, *Debt: Modifications and Extinguishments*.

Under the book-value method, there is no gain or loss reported on bond conversion, because the book value of the bond is the basis to credit equity. The entry to record the conversion using this method follows:

Bonds payable: At face value

Premium on bonds payable: Unamortized amount

Discount on bonds payable: Unamortized amount

Common stock: At par value of shares issued

Additional paid-in-capital: For the difference between the book value of the bonds and the par value of common stock

Under the market value methods, gain or loss arises because the book value of the bond differs from the market value of the bond or market value of the stock, which is the basis to credit the equity account.

EXAMPLE

A $200,000 bond with an unamortized premium of $17,000 is converted to common stock. There are 200 bonds ($200,000/$1,000). Each bond is convertible into 100 shares of stock. Therefore, there are 20,000 shares of common stock to be issued. Par value per share is $8. The market value of the stock is $12 per share. The market value of the bond is 115%.

Using the book value of bond method, the journal entry for the conversion is:

Bonds payable	200,000

Premium on bonds payable	17,000	
Common stock (20,000 × $8)		160,000
Premium on common stock		57,000

Using the market value of stock method, the journal entry is:

Bonds payable	200,000	
Premium on bonds payable	17,000	
Loss on bond conversion	23,000	
Common stock (20,000 × $8)		160,000
Premium on common stock (20,000 × $4)		80,000

20,000 shares × $12 = $240,000

Using the market value of bond method, the journal entry is:

Bonds payable		200,000
Premium on bonds payable		17,000
Loss on bond conversion		13,000
Common stock (20,000 × $8)		160,000
Premium on common stock		70,000

$200,000 × 115% = $230,000

EXAMPLE

On July 1, 2X13, Klemer Company converted $1,000,000 of its 10% convertible bonds into 25,000 shares of $3 par value common stock. On the date of the conversion, the book value of the bonds was $1,200,000; the market value of the bonds was $1,250,000 and the market price of the stock was $54 per share. Using the preferred book value of bond method, the journal entry would be:

Bonds payable	1,000,000	
Premium on bonds payable	200,000	
Common Stock (25,000 × $3)		75,000
Paid-in-capital		1,125,000

EXAMPLE

A convertible bond having a face value of $80,000 with an unamortized discount of $5,000 is converted into 10,000 shares of $6 par value stock. Under the book value method, the journal entry for the conversion is:

Bonds payable	80,000	
Discount on bonds payable		5,000
Common stock (10,000 × $6)		60,000
Paid-in-capital		15,000

ASC 470-20-35-11, *Debt: Debt with Conversion and Other Options*, states that if the debt agreement specifies that accrued interest at the conversion date is forfeited by the bondholder, such accrued interest (net of tax) since the last interest date to the date of conversion should be treated as interest expense, with a corresponding credit to capital, because it is considered an element of the cost of the securities issued.

ASC 470-20-55-68, *Debt: Debt with Conversion and Other Options*, states that equity securities issued on the conversion of a debt instrument that has a substantive conversion feature at the issue (commitment) date should be treated for accounting purposes as a conversion if the debt security becomes convertible because the issuer has exercised a call option. In this case, gain or loss is not recorded. However, in the event that there is no substantive conversion feature at the issue date, the conversion should be treated as a debt extinguishment if the debt security becomes convertible because of the issuer's exercise of a call option based on the debt instrument's original conversion terms. In this situation, the fair value of the equity security should be treated as a part of the price of reacquiring the debt. In determining if a conversion feature is substantive, consideration should be given to assumptions and available market data.

Other authoritative sources of GAAP with regard to convertible debt may be found in ASC 815-15-55, *Derivatives and Hedging: Embedded Derivatives*.

Early Extinguishment of Debt

ASC 860-50-35-3 and 35-5 through 35-7, *Transfers and Servicing: Servicing Assets and Liabilities*, ASC 860-50, *Transfers and Servicing: Servicing Assets and Liabilities*, and ASC 470-50-45, *Debt: Modifications and Extinguishments*, cover the accounting, reporting, and disclosures associated with retiring debt. Long-term debt may be called before its maturity date and new debt issued instead at a lower interest

rate. On the other hand, the company may just retire the long-term debt early because it has excess funds and wants to avoid paying interest charges and having debt on its balance sheet. (A call provision allows the issuer the right to retire all or part of the debt prior to the maturity date, typically at a premium price.)

If a defeasance clause exists instead of a call provision, the issuer may satisfy the obligation and receive a lien release without retiring the debt. In a defeasance arrangement, the old debt is satisfied under law with a gain or loss being recognized.

According to ASC 860-50-35-3, when financial assets are transferred, any resulting debt or derivatives must be measured initially at fair value. The amortization of a servicing liability is proportionate based on the time period associated with the net servicing loss or gain. A change in fair value must be also considered. Disclosure is required of the nature of any limitations placed on assets set aside to pay debt payments.

ASC 860-50-35-3 also addresses the issue of a debtor becoming secondarily liable, such as because of a third-party assumption and a creditor's release. In this case, the original party is considered a guarantor. It is necessary to recognize a guarantee obligation based on the likelihood that the third party will pay. The guarantee obligation must initially be recognized at fair value. The guarantee obligation serves either to reduce the gain or increase the loss on debt extinguishment.

In an advance refunding arrangement, new debt is issued to replace the old debt issue that cannot be called. The amount received from issuing the new debt is used to buy high-quality investments, which are retained in an escrow account. The income earned on the investments in the escrow account is used to pay the interest and/or principal on the existing debt for a period ending on the date the existing debt is callable. When the call of the existing date occurs, the balance in the escrow account is used to pay the call premium. Any residual remaining is used to pay any interest due on the existing debt as well as the principal balance.

The reacquisition price for debt includes the call premium and any other associated costs (e.g., prepayment penalties, reacquisition costs) to buy back the debt. If the extinguishment is based on the issuance of securities, the reacquisition price is the fair value of the securities issued. The net carrying amount of the debt extinguished is its book value (including any associated unamortized discount or premium) and any other issuance costs (e.g., accounting, underwriter's commissions, legal). Any unamortized bond issue costs reduce the carrying value.

ASC 470-50-15-2, *Debt: Modifications and Extinguishments*, stipulates that the gain or loss on extinguishment is based on either the fair value of the stock issued in exchange for the debt or the value of the debt extinguished, whichever is more clearly evident. The gain or loss on the retirement of debt equals the difference between the retirement price and the carrying value of the bonds. The gain or loss on an extinguishment of debt is an ordinary item.

Debt is considered extinguished when the debtor is relieved of the principal liability and will most likely not need to make future payments. This occurs when either the debtor pays the debt or reacquires the

debt in the securities market, or the debtor is legally discharged and it is probable that the debtor will not need to make future payments as guarantor of the obligation. The latter occurs when the debtor is legally discharged as the primary obligor but is secondarily liable for the debt.

EXAMPLE

A $300,000 bond payable with an unamortized bond discount of $7,000 is called at 90%. The journal entry is:

Bonds payable	300,000	
Discount on bonds payable		7,000
Cash (90% × $300,000)		270,000
Gain		23,000

EXAMPLE

On January 1, 2X13, a company called 500 outstanding, 8%, $1,000 face value bonds at 108%. The unamortized bond premium on this date was $25,000. The journal entry is:

Bonds payable	500,000	
Premium on bonds payable	25,000	
Loss	15,000	
Cash ($500,000 × 108%)		540,000

EXAMPLE

A bond having a face value of $300,000 and an unamortized discount of $8,000 is called at 102%. Unamortized deferred issue costs representing legal and accounting fees are $12,000. The journal entry for the extinguishment is:

Bonds payable	300,000	
Loss	26,000	
Cash ($300,000 × 102%)		306,000
Discount on bonds payable		8,000

Deferred issue costs	12,000

No gain or loss arises from an early extinguishment of a fully owned subsidiary's mandatory preferred stock by the parent company. It should be accounted for as a capital transaction. On the other hand, if a subsidiary has an outstanding third-party debt instrument that is purchased by the parent, a gain or loss is reported in consolidation equal to the difference between the carrying value of the debt on the subsidiary books and the purchase price paid by the parent. This accounting is also applicable if it is the parent that issued the debt and it is the subsidiary that purchases it.

There should be footnote disclosure in one footnote or cross-referenced footnotes concerning the extinguishment as follows:

- Description of the extinguishment transaction including the funding used for it.
- Direct and indirect guarantees of indebtedness of others (this includes a situation in which the debtor is released as the primary obligor but is contingently liable).

When a debtor contracts with a holder of its debt to redeem the obligation within one year for a predetermined amount, it is classified as a current liability. The debtor recognizes a loss when the contract becomes legally binding on the parties. However, a gain is not recognized until the redemption actually occurs.

Conversion Spread

As per ASC 470-20-40-12, *Debt: Debt with Conversion and Other Options*, an issuer should take into account only the *cash* payment when calculating a gain or loss on extinguishment of a liability or convertible debt if the accreted value is settled in cash and the embedded equity instrument (excess conversion spread) is *not* taken into account in calculating the gain or loss.

ASC 310-20-35-13, *Receivables: Nonrefundable Fees and Other Costs*, relates to modifications in mortgage loan payments.

Extinguishment of Tax-Exempt Debt

ASC 840-30-35-31, *Leases: Capital Leases*, stipulates that if a modification is made to a rental because of a lessor's refunding of tax-exempt debt and the lessee receives the ensuing advantages and the modified lease qualifies as a capital lease to the lessee or a direct financing lease to the lessor, the change in the lease may qualify as a debt extinguishment. If so, the lessee adjusts the lease debt to its discounted value of future minimum lease payments based on the modified (new) arrangement. The

discount rate used is the interest rate associated with the new lease contract. An ensuing gain or loss is considered as being associated with an early debt extinguishment resulting in an ordinary gain or loss. Mean-while, the lessor adjusts its lease receivable account for the difference between the discounted value of payments associated with the old and modified (new) agreement. The ensuing gain or loss is recognized in the current year's income statement.

Imputing Interest on Noninterest Notes Payable

ASC 835-30-05, *Interest: Imputation of Interest*, covers notes with no stated rate of interest. If the face value of a note differs from the consideration given or received, an interest calculation is required to avoid profit misstatement. Interest is imputed on noninterest-bearing notes, on notes with unreasonably low interest rates relative to market rates, and notes with face values substantially different from the prevailing selling prices of such notes.

If a note is issued just for cash, the note is recorded at the cash exchanged regardless of whether the interest rate is realistic or of the amount of the face value of the note. The present value of the note at the issue date is presumed to be the cash transacted.

If a note is exchanged for property, goods, or services, it is assumed that the interest rate is fair and appropriate. However, if the interest rate is not reasonable and adequate, the note must be recorded at the fair market value of the goods or services or at an amount approximating fair value. If fair value is nonascertainable for the product or service, the discounted present value of the note must be used.

The imputed interest rate is the one in which an independent borrower or lender would have engaged in a similar transaction. In determining the imputed interest rate, consideration should be given to such factors as credit rating, tax effect, collateral requirements, and restrictions.

It is the “going” interest rate the borrower would have paid for financing in an arm's-length transaction. There are several considerations involved in determining an appropriate interest rate, such as prevailing market interest rates, the prime interest rate, security pledged, loan restrictions, issuer's financial position, tax rate, and tax planning issues.

EXAMPLE

> ABC Company sells equipment to XYZ Company on January 1, 2X13, in exchange for a $50,000 noninterest-bearing note due December 31, 2X14. There is no established price for this equipment, and the prevailing interest rate for this type of note is 10%. The present value of $1 at 10% for 2 years is 0.826446. Interest income will be recognized by ABC Company each year and the discount amortized.

Date	Interest Income	Discount Amortized	Carrying Amount
1/1/2X13			$41,322
12/31/2X13	$4,132	4,132	45,454
12/31/2X14	4,546*	4,546	50,000

* $1 adjustment for rounding

GAAP guidance on the imputation of interest (ASC 835-30-05) applies to long-term payables and receivables. Short-term payables and receivables are usually recorded at face value because the additional work of amortizing a discount or premium on a short-term note does not justify the information benefit derived.

In addition, it is not applicable to receivables or payables in the ordinary course of business, amounts not requiring repayment, security deposits, parent/subsidiary transactions, and customary lending of banks and other similar financial institutions.

The difference between the face value of a note and its present value constitutes a discount or premium, which is to be an increment or decrement to interest over the life of the note. The present value of the payments of the note depends on the imputed interest rate.

Discount or premium is amortized using the interest method, which results in a constant interest rate. Amortization equals the interest rate multiplied by the present value of the note payable at the beginning of the period. GAAP states that discount or premium is not an asset or liability separable from the related note. A discount or premium should therefore be reported in the balance sheet as a direct deduction from or addition to the face amount of the note.

The borrower recognizes interest expense while the lender recognizes interest revenue. Issuance costs are accounted for as a deferred charge.

The presentation of the note payable or note receivable in the balance sheet follows:

Notes payable (face amount)
Less: discount
    Equals present value (principal)
Notes receivable (face amount)
Add: premium
    Equals present value (principal)

EXAMPLE

On January 1, 2X12, a fixed asset is purchased for $40,000 cash and the incurrence of a $60,000, five-year, noninterest-bearing note payable. An imputed interest rate equals 10%. The present value factor for *n* = 5, *i* = 10% is .62 (Table 1 in the Appendix). The journal entries follow:

1/1/2X12		
Fixed asset ($40,000 + $37,200)	77,200	
Discount	22,800	
Notes payable		60,000
Cash		40,000
Present value of note = $60,000 × .62 = $37,200		

On 1/1/2X12, the balance sheet presents:

Notes payable	$60,000
Less: discount	22,800
Present value	$37,200

12/31/2X12		
Interest expense	3,720	
Discount		3,720
10% × $37,200 = $3,720		

On 1/1/2X13, the balance sheet presents:

Notes payable	$60,000
Less: discount ($22,800 - $3,720)	19,080
Present value	$40,920

12/31/2X13		
Interest expense	4,092	
Discount		4,092
10% × $40,920 = $4,092		

Exit or Disposal Activities

ASC 420-10-05, *Exit or Disposal Cost Obligations: Overall*, relates to costs (e.g., operating lease termination costs, one-time termination benefits to current employees, costs to consolidate facilities or relocate workers) associated with a restructuring, discontinued operation, plant closing, or other exit or disposal activity. Restructurings include altering the management structure, relocating business

operations, closing a location, and ceasing a business line. These costs are recognized as incurred (*not* at the commitment date to an exit plan) based on fair value along with the related liability. Therefore, the company must actually incur the liabilities before recognition may be made. If fair value cannot reasonably be estimated, recognizing the liability must be postponed to such time.

The fair value of a liability is the amount the liability can be settled for in a current transaction between willing parties, that is, other than in a forced or liquidated transaction. The best reflection of fair value is quoted market prices in active markets. If such is unavailable, fair value should be estimated based on the best data available.

The initiation date of an exit or disposal activity is when management obligates itself to a plan to exit or otherwise dispose of a long-lived asset, if the activity includes worker termination.

In years following initial measurement, changes to the liability should be measured based on the credit-adjusted risk-free rate that was used to initially measure the liability. The cumulative effect of a change due to revising either the timing or the amount of estimated cash flows shall be recognized as an adjustment to the liability in the year of change and reported in the same line items in the income statements used when the related costs were recognized initially. Changes due to the passage of time shall be recognized as an increase in the carrying value of the liability and as an expense (e.g., accretion expense).

Examples of costs attributable to exit or disposal activities are included in income from continuing operations unless they apply to discontinued operations.

If an event arises that discharges a company's obligation to settle a liability for a cost associated with an exit or disposal activity recognized in a prior year, the liability and the related costs are reversed.

The liability to end a lease or other legal agreement prior to the end of its term is measured at its fair value when the company cancels the contract. The estimated liability for future costs to be incurred is measured at its fair value when the business no longer uses its right under the contract such as using rented property. In the case of an operating lease, the obligation's fair value at the date the entity no longer uses the property is computed on the basis of the balance of the lease payments less any expected sublease rentals. However, the remaining rentals cannot be reduced to less than zero.

Consideration is given to when and how much a liability for one-time termination benefits is, based on whether employees are obligated to work until they are let go in order to be eligible for termination benefits and, if such is the case, whether workers will be kept to work beyond a minimum retention period. The minimum retention period cannot be more than the legal notification period or, in the event none exists, 60 days.

For situations in which workers do not have to work until they are let go to obtain termination benefits or will not be retained to work beyond a minimum retention period, the obligation for termination benefits is recorded at fair value at the date of communication.

If workers must work until they are terminated so as to obtain benefits and will be kept to work beyond the minimum retention period, the liability is initially measured at the communication date, based on the fair value as of the termination date but recorded ratably over future service years.

ASC 420-10-15-3, *Exit or Disposal Cost Obligations: Overall*, generally requires the recognition of costs related to one-time employee termination benefits at the communication date and contract termination costs at the cease-use date.

The following should be footnoted:

- A description of the exit or disposal activity and the expected completion date.
- The place in the income statement or statement of activities where exit or disposal costs are presented.
- If a liability for a cost is not recorded because fair value is not reasonably estimated, that should be noted along with the reasons.
- For each major kind of cost attributable to the exit activity, the total cost expected, the amount incurred in the current year, and the cumulative amount to date.
- Reconciliation of the beginning and ending liability balances presenting the changes during the year associated to costs incurred and charged to expense, costs paid or otherwise settled, and any adjustments of the liability along with the reasons for doing so.

Third-Party Credit Enhancement

ASC 820-10-25-1, 25-2 and 50-4A discusses liabilities issued with an inseparable third-party credit enhancement. Debt securities may be issued with a third-party credit enhancement. An example is a financial guarantee from an unrelated third party who guarantees the issuer's payment obligations. That guarantee may be purchased by the issuer who combines it with the debt and issues the combined security to an investor. In issuing debt combined with the guarantee, the issuer can obtain a lower interest rate and/or receive higher proceeds.

This guidance applies to an issuer's accounting for debt issued with an inseparable third-party credit enhancement that is measured or disclosed at fair value.

There should be disclosure of the credit enhancement. An issuer should not include the effect of the third-party credit enhancement in the fair value measurement of the liability. Therefore, the fair value measurement is determined taking into account the issuer's credit standing (without considering the third-party guarantor's credit standing). The unit of accounting for debt does not include the guarantee (or other third-party credit enhancement), and the guarantee does not represent an asset of the issuer. The guarantee is for the investor's benefit.

Environmental Liabilities

In determining a loss contingency to accrue for environmental liabilities, the following should be taken into account:

- Type and degree of hazardous waste at a site.
- Remediation approaches available and remedial action plan.
- Level of acceptable remediation.
- Other responsible parties and their extent of liability.

Securities and Exchange Commission Staff Accounting Bulletin No. 92 requires full disclosure of environmental problems, how environmental liabilities are determined, "key" factors associated with the environment as it affects the business, and future contingencies. Depending on the circumstances, a liability and/or footnote disclosure would be required. Examples of environmental importance requiring accounting or disclosure recognition based on the facts follow:

- Information on site remediation projects, such as current and future costs, and remediation trends. (Site remediation may include hazard waste sites.)
- Contamination due to environmental health and safety problems.
- Legal and regulatory compliance issues, such as with regard to cleanup responsibility.
- Water or air pollution.

ASC 410-30-45, *Asset Retirement and Environmental Obligations: Environmental Obligations*, stipulates that if a liability for environmental losses is required, it should be reduced only when there is probable realization of recovery from a third party. However, both the liability and probable recovery must be shown separately. The present value of payments associated with a liability may be recognized only when the future cash flows are reliably determinable in amount and timing. If the liability is discounted, so must be the anticipated recovery. Disclosure is required of the gross cash flows and the discount rate used to determine present value.

According to ASC 410-30-55-18, *Asset Retirement and Environmental Obligations: Environmental Obligations*, in general, environmental contamination treatment costs should be expensed. However, in the following cases only, the company may elect to either expense or capitalize the costs:

- The expenditures made are to get the property ready for sale.
- The expenditures prevent or lessen environmental contamination that may result from *future* activities of property owned.

- The expenditures extend the life or capacity of the asset or enhance the safety of the property.

Other authoritative guidance for the accrual and disclosure of environmental liabilities include ASC 450-20-25, 4-5, *Contingencies: Loss Contingencies*, ASC 210-20-45, *Balance Sheet: Offsetting*, and ASC 410-30-45-6, *Asset Retirement and Environmental Obligations: Environmental Obligations*.

Environmental costs should be allocated across departments, products, and services.

Disclosure of Long-Term Obligations

According to ASC 440-10-50-2, *Exit or Disposal Cost Obligations: Overall*, the following must be disclosed with respect to long-term obligations for each of the five years following the balance sheet date:

- The total payments for unconditional purchase obligations that have been recognized on the purchaser's balance sheet. An unconditional purchase obligation is a duty to transfer a fixed or minimum amount of funds at a later date or to transfer products or services at constant or minimum prices.
- The combined aggregate amount of maturities and sinking fund requirements for all long-term borrowings.
- The amount of redemption requirements for all issues of capital stock that are redeemable at fixed or determinable prices on fixed or determinable dates.

Fair Value Option for Issued Debt Instruments

The fair value option was created to increase the relevancy of financial statements. Under this option (see the “Fair Value Option for Financial Assets and Financial Liabilities” section in this course for greater details), companies can now value their own liabilities as well as most other financial instruments in their accounts at the fair value. If the fair value option is chosen for a given financial instrument, all unrealized holding gains and losses relating to that instrument must be recorded in net income until the debt is retired. If a company chooses the fair value option for debt instruments that it issued (e.g., bonds payable), it is required to record any change in the fair value of these instruments each period as part of the entity's unrealized holding gains or losses. This amount is then reported in the entity's net income for the period. Changes in overall market interest rates, for example, would affect the fair value of an entity's debt. In addition, a change in the credit rating of the company would have a similar affect. Each period, the entity's bonds payable must be reevaluated for any change in fair value and that change must be recorded in net income.

Commitments

Footnote disclosure may be required of commitments, including their description and amount. Examples of such commitments are those associated with forward exchange contracts; employment agreements; agreements not to acquire another company, to reduce debt by a certain amount, not to issue debt, and not to issue debt exceeding a specified amount; agreements to maintain a minimum ratio (e.g., current ratio); and agreements to purchase a specified amount of assets.

EXAMPLE

On January 1, 2X13, Walter Company entered into a three-year noncancelable contract to buy up to 600,000 units of a product each year at $.15 per unit with a minimum annual guarantee purchase of 150,000. At year-end 2X13, 280,000 units of inventory were in stock. It is expected that each unit can be sold as scrap for $.04 per unit. The estimated loss on the purchase commitments to be recorded in 2X13 is:

(150,000 units × 2 years remaining on contract × $.11 unit cost) = $33,000

ASC 952-605-25, *Franchisors: Revenue Recognition*, provides disclosures as well as recognition and measurement provisions that require a liability to be recorded for certain guarantees at fair value.

Offsetting Assets and Liabilities

In most cases, debts owed between two parties, a debtor and creditor, may be offset. However, a right to set off may be prohibited or restricted under federal or state bankruptcy law if the debtor is filing for bankruptcy. When related assets and liabilities are offset because of a right of setoff, they are shown in the balance sheet as a net amount.

ASC 210-20-45-1, *Balance Sheet: Offsetting* indicates that an asset may be used to offset a liability if all of the following conditions are satisfied:

- The reporting entity intends to set off.
- A contractual right of setoff exists.
- The setoff is legal.

- Each of the two parties owes a determinable amount.

Note: A setoff right is a debtor's legal right to discharge an obligation owed another by applying against the obligation funds the other party owes the debtor.

An asset and liability may still be offset if they are in different currencies or have different interest rates associated with them. However, if the maturities of the asset and liability differ, only the company with the earlier maturity may offset.

A government security can be used to offset a tax obligation only if the security can be used as a direct offset of taxes due.

ASC 210-20-05, *Balance Sheet: Offsetting*, may allow for the offsetting of fair value amounts associated with forward, multiple swap, option, and conditional or exchange contracts in a master netting arrangement. In other words, the fair value of contracts with a loss may offset the fair value of contracts with a gain. Reference may be made to EITF Consensus Summary No. 86-25, *Offsetting Foreign Currency Swaps*.

ASC 210-20-45-11, *Balance Sheet: Offsetting*, discusses when amounts recognized as payables in repurchase contracts may be used to offset the amounts attributable to receivables in reverse repurchase agreements. Once a decision is made to offset or not to offset, it must be applied consistently. An offset of the payables and receivables is allowed if all of the following conditions are satisfied:

- The reporting company will use the same account at the clearing financial institution at the settlement date to transact the cash inflows and cash outflows associated with the contracts.
- There are adequate funds available at the settlement date for each party.
- The agreements are executed with the same counterparty.
- A master netting arrangement is involved.
- The settlement dates are the same for both agreements.
- The underlying securities are in “book entry” form.

An insurance recovery cannot be used to offset the associated litigation liability, because they do not involve the same two parties. **Recall:** A condition for setoff is that the two parties have a receivable and payable of determinable amounts.

A seller is not allowed to offset an installment note receivable against a bank debt with recourse, irrespective of whether the debt has a put option associated with it, making the debt a secured nonrecourse obligation.

Presentation of Long-Term Debt

Companies that have large amounts and numerous issues of long-term debt frequently report only one amount in the balance sheet, supported with comments and schedules in the accompanying notes. Long-term debt that **matures within one year** should be reported as a current liability, unless using noncurrent assets to accomplish retirement. If the company plans to refinance debt, convert it into stock, or retire it from a bond retirement fund, it should continue to report the debt as noncurrent. However, the company should disclose the method it will use in its liquidation.

Note disclosures generally indicate the nature of the liabilities, maturity dates, interest rates, call provisions, conversion privileges, restrictions imposed by the of the long-term debt should also be disclosed if it is practical to estimate fair value. Finally, companies must disclose future payments for sinking fund requirements and maturity amounts of long-term debt during each of the next five years. These disclosures aid financial statement users in evaluating the amounts and timing of future cash flows. Exhibit 7 shows an example of the type of information provided for ABC Co. Note that if the company has any off-balance-sheet financing, it must provide extensive note disclosure.

EXHIBIT 7: LONG-TERM DEBT DISCLOSURE

ABC Co.	Mar. 3,	Feb. 25,
(dollars in millions)	2012	2011
Total current assets	$9,081	$7,985
Current liabilities		
Accounts payable	$3,934	$3,234
Unredeemed gift card liabilities	496	469
Accrued compensation and related expenses	332	354
Accrued liabilities	990	878
Accrued income taxes	489	703
Short-term debt	41	-
Current portion of long-term debt	19	418
Total current liabilities	6,301	6,056
Long-term liabilities	443	373
Long-term debt	590	178
5. Debt (in part)	Mar. 3,	Feb. 25,
	2012	2011
Convertible subordinated debentures, unsecured, due 2022, interest rate 2.25%	$402	$402

Financing lease obligations, due 2009 to 2023, interest rates ranging from 3.0% to 6.5%	171	157
Capital lease obligations, due 2008 to 2026, interest rates ranging from 1.8% to 8.0%	24	27
Other debt, due 2010, interest rate 8.8%	12	10
Total debt	609	596
Less: Current portion	(19)	(418)
Total long-term debt	$590	$178

Certain debt is secured by property and equipment with a net book value of $80 and $41 at March 3, 2010, and February 25, 2009, respectively.

At March 3, 2010, the future maturities of long-term debt, including capitalized leases, consisted of the following:

Fiscal Year	
2010	27
2011	18
2012	420
Thereafter	107
	$572

The fair value of debt approximated $683 and $693 at March 3, 2010, and February 25, 2009, respectively, based on the ask prices quoted from external sources, compared with carrying values of $650 and $596, respectively.

IFRS connection

IFRS and U.S. GAAP have similar definitions for liabilities. IFRS related to reporting and recognition of liabilities is found in IAS I (Presentation of Financial Statements) and IAS 37 (Provisions, Contingent Liabilities, and Contingent Assets).

- Similar to U.S. practice, IFRS requires that companies present current and noncurrent liabilities on the face of the balance sheet, with current liabilities generally presented in order of liquidity.
- Under IFRS, the measurement of a provision related to a contingency is based on the best estimate of the expenditure required to settle the obligation. If a range of estimates is predicted and no amount in the range is more likely than any other amount in the range, the "mid-point" of the range is used to measure the liability. In U.S GAAP, the minimum amount in a range is used.
- Both GAAPs prohibit the recognition of liabilities for future losses. However, IFRS permits recognition of a restructuring liability, once a company has committed to a restructuring plan. U.S. GAAP has additional criteria (i.e., related to communicating the plan to employees) before a restructuring liability can be established.
- IFRS and U.S. GAAP are similar in the treatment of asset retirement obligations (AROs). However, the recognition criteria for an ARO are more stringent under U.S. GAAP: The ARO is not recognized unless there is a present legal obligation and the fair value of the obligation can be reasonably estimated.

- IFRS and U.S. GAAP are similar in their treatment of contingencies. However, the criteria for recognizing contingent assets are less stringent in the U.S. Under U.S. GAAP, contingent assets for insurance recoveries are recognized if probable; IFRS requires the recovery be “virtually certain” before recognition of an asset is permitted.

Chapter 2 Review Questions

1. A bond issued on June 1, 2X13 has interest payment dates of April 1 and October 1. Bond interest expense for the year ended December 31, 2X13 is for a period of

A. Three months.

B. Four months.

C. Six months.

D. Seven months.

2. On March 1, 2X13, Clark Co. issued bonds at a discount. Clark incorrectly used the straight-line method instead of the effective interest method to amortize the discount. How were the following amounts, as of December 31, 2X13, affected by the error?

A. Bond Carrying Amount is Overstated, and Retained Earnings is Overstated
B. Bond Carrying Amount is Understated, and Retained Earnings is Understated
C. Bond Carrying Amount is Overstated, and Retained Earnings is Understated
D. Bond Carrying Amount is Understated, and Retained Earnings is Overstated

3. On March 31, 2X13, Ashley, Inc.'s bondholders exchanged their convertible bonds for common stock. The carrying amount of these bonds on Ashley's books was less than the market value but greater than the par value of the common stock issued. If Ashley used the *book-value method* of accounting for the conversion, which of the following statements correctly states an effect of this conversion?

A. Equity is increased.

B. Additional paid-in capital is decreased.

C. Retained earnings is increased.

D. An extraordinary loss is recognized.

4. On March 1, 2X08, Somar Co. issued 20-year bonds at a discount. By September 1, 2X13, the bonds were quoted at 106 when Somar exercised its right to retire the bonds at 105. How should Somar report the bond retirement on its 2X13 income statement?

A. A gain in continuing operations.

B. A loss in continuing operations.

C. An extraordinary gain.

D. An extraordinary loss.

5. The discount resulting from the determination of a note payable's present value should be reported on the balance sheet as a(n)

A. Addition to the face amount of the note.

B. Deferred charge separate from the note.

C. Deferred credit separate from the note.

D. Direct deduction from the face amount of the note.

Glossary

CONTINGENCY. An existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.

CONTINGENT LIABILITIES. Obligations that area dependent upon the occurrence or nonoccurrence of one or more future events to confirm either the amount payable, the payee, the date payable, or its existence.

CONVERTIBLE, COMMODITY-BACKED, AND DEEP-DISCOUNT BONDS. If bonds are convertible into other securities of the corporation for a specified time after issuance, they are convertible bonds. Two types of bonds have been developed in an attempt to attract capital in a tight money market—commodity-backed bonds and deep-discount bonds. Commodity-backed bonds (also called asset-linked bonds) are redeemable in measures of a commodity, such as barrels of oil, tons of coal, or ounces of rare metal.

CURRENT MATURITIES OF LONG-TERM DEBT. The portion of bonds, mortgages notes, and other long-term indebtedness that matures within the next fiscal year.

DISCOUNT ON NOTES PAYABLE. The difference between the present value of a zero-interest-bearing not and the face value of the note at maturity.

INCOME AND REVENUE BONDS. Income bonds pay no interest unless the issuing company is profitable. Revenue bonds, so called because the interest on them is paid from specified revenue sources, are most frequently issued by airports, school districts, counties, toll-road authorities, and governmental bodies.

OFF-BALANCE-SHEET FINANCING. An attempt to borrow monies in such a way that the obligations are not recorded.

REGISTERED AND BEARER (COUPON) BONDS. Bonds issued in the name of the owner are registered bonds and require surrender of the certificate and issuance of a new certificate to complete a sale. A bearer or coupon bond, however, is not recorded in the name of the owner and may be transferred from one owner to another by mere delivery.

SECURED AND UNSECURED BONDS. Secured bonds are backed by a pledge of some sort of collateral. Mortgage bonds are secured by a claim on real estate. Collateral trust bonds are secured by stocks and bonds of other corporations. Bonds not backed by collateral are unsecured. A debenture bond is unsecured. A "junk bond" is unsecured and also very risky, and therefore pays a high interest rate. Companies often use these bonds to finance leveraged buyouts.

TERM, SERIAL BONDS, AND CALLABLE BONDS. Bond issues that mature on a single date are called term bonds; issues that mature in installments are called serial bonds. Serially maturing bonds are frequently

used by school or sanitary districts, municipalities, or other local taxing bodies that receive money through a special levy. Callable bonds give the issuer the right to call and retire the bonds prior to maturity.

TROUBLE DEBT RESTRUCTURING. When a 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.

Appendix

TABLE 1

PRESENT VALUE OF $1

(n) Periods	2%	2½%	3%	4%	5%	6%
1	1.02000	1.02500	1.03000	1.04000	1.05000	1.06000
2	1.04040	1.05063	1.06090	1.08160	1.10250	1.12360
3	1.06121	1.07689	1.09273	1.12486	1.15763	1.19102
4	1.08243	1.10381	1.12551	1.16986	1.21551	1.26248
5	1.10408	1.13141	1.15927	1.21665	1.27628	1.33823
6	1.12616	1.15969	1.19405	1.26532	1.34010	1.41852
7	1.14869	1.18869	1.22987	1.31593	1.40710	1.50363
8	1.17166	1.21840	1.26677	1.36857	1.47746	1.59385
9	1.19509	1.24886	1.30477	1.42331	1.55133	1.68948
10	1.21899	1.28008	1.34392	1.48024	1.62889	1.79085
11	1.24337	1.31209	1.38423	1.53945	1.71034	1.89830
12	1.26824	1.34489	1.42576	1.60103	1.79586	2.01220
13	1.29361	1.37851	1.46853	1.66507	1.88565	2.13293
14	1.31948	1.41297	1.51259	1.73168	1.97993	2.26090
15	1.34587	1.44830	1.55797	1.80094	2.07893	2.39656
16	1.37279	1.48451	1.60471	1.87298	2.18287	2.54035
17	1.40024	1.52162	1.65285	1.94790	2.29202	2.69277
18	1.42825	1.55966	1.70243	2.02582	2.40662	2.85434
19	1.45681	1.59865	1.75351	2.10685	2.52695	3.02560
20	1.48595	1.63862	1.80611	2.19112	2.65330	3.20714
21	1.51567	1.67958	1.86029	2.27877	2.78596	3.39956
22	1.54598	1.72157	1.91610	2.36992	2.92526	3.60354
23	1.57690	1.76461	1.97359	2.46472	3.07152	3.81975
24	1.60844	1.80873	2.03279	2.56330	3.22510	4.04893
25	1.64061	1.85394	2.09378	2.66584	3.38635	4.29187
26	1.67342	1.90029	2.15659	2.77247	3.55567	4.54938
27	1.70689	1.94780	2.22129	2.88337	3.73346	4.82235
28	1.74102	1.99650	2.28793	2.99870	3.92013	5.11169
29	1.77584	2.04641	2.35657	3.11865	4.11614	5.41839
30	1.81136	2.09757	2.42726	3.24340	4.32194	5.74349
31	1.84759	2.15001	2.50008	3.37313	4.53804	6.08810
32	1.88454	2.20376	2.57508	3.50806	4.76494	6.45339
33	1.92223	2.25885	2.65234	3.64838	5.00319	6.84059
34	1.96068	2.31532	2.73191	3.79432	5.25335	7.25103
35	1.99989	2.37321	2.81386	3.94609	5.51602	7.68609
36	2.03989	2.43254	2.89828	4.10393	5.79182	8.14725
37	2.08069	2.49335	2.98523	4.26809	6.08141	8.63609
38	2.12230	2.55568	3.07478	4.43881	6.38548	9.15425
39	2.16474	2.61957	3.16703	4.61637	6.70475	9.70351
40	2.20804	2.68506	3.26204	4.80102	7.03999	10.28572

8%	9%	10%	11%	12%	15%	(n) Periods
1.08000	1.09000	1.10000	1.11000	1.12000	1.15000	1
1.16640	1.18810	1.21000	1.23210	1.25440	1.32250	2
1.25971	1.29503	1.33100	1.36763	1.40493	1.52088	3
1.36049	1.41158	1.46410	1.51807	1.57352	1.74901	4
1.46933	1.53862	1.61051	1.68506	1.76234	2.01136	5
1.58687	1.67710	1.77156	1.87041	1.97382	2.31306	6
1.71382	1.82804	1.94872	2.07616	2.21068	2.66002	7
1.85093	1.99256	2.14359	2.30454	2.47596	3.05902	8
1.99900	2.17189	2.35795	2.55803	2.77308	3.51788	9
2.15892	2.36736	2.59374	2.83942	3.10585	4.04556	10
2.33164	2.58043	2.85312	3.15176	3.47855	4.65239	11
2.51817	2.81267	3.13843	3.49845	3.89598	5.35025	12
2.71962	3.06581	3.45227	3.88328	4.36349	6.15279	13
2.93719	3.34173	3.79750	4.31044	4.88711	7.07571	14
3.17217	3.64248	4.17725	4.78459	5.47357	8.13706	15
3.42594	3.97031	4.59497	5.31089	6.13039	9.35762	16
3.70002	4.32763	5.05447	5.89509	6.86604	10.76126	17
3.99602	4.71712	5.55992	6.54355	7.68997	12.37545	18
4.31570	5.14166	6.11591	7.26334	8.61276	14.23177	19
4.66096	5.60441	6.72750	8.06231	9.64629	16.36654	20
5.03383	6.10881	7.40025	8.94917	10.80385	18.82152	21
5.43654	6.65860	8.14028	9.93357	12.10031	21.64475	22
5.87146	7.25787	8.95430	11.02627	13.55235	24.89146	23
6.34118	7.91108	9.84973	12.23916	15.17863	28.62518	24
6.84847	8.62308	10.83471	13.58546	17.00000	32.91895	25
7.39635	9.39916	11.91818	15.07986	19.04007	37.85680	26
7.98806	10.24508	13.10999	16.73865	21.32488	43.53532	27
8.62711	11.16714	14.42099	18.57990	23.88387	50.06561	28
9.31727	12.17218	15.86309	20.62369	26.74993	57.57545	29
10.06266	13.26768	17.44940	22.89230	29.95992	66.21177	30
10.86767	14.46177	19.19434	25.41045	33.55511	76.14354	31
11.73708	15.76333	21.11378	28.20560	37.58173	87.56507	32
12.67605	17.18203	23.22515	31.30821	42.09153	100.69983	33
13.69013	18.72841	25.54767	34.75212	47.14252	115.80480	34
14.78534	20.41397	28.10244	38.57485	52.79962	133.17552	35
15.96817	22.25123	30.91268	42.81808	59.13557	153.15185	36
17.24563	24.25384	34.00395	47.52807	66.23184	176.12463	37
18.62528	26.43668	37.40434	52.75616	74.17966	202.54332	38
20.11530	28.81598	41.14479	58.55934	83.08122	232.92482	39
21.72452	31.40942	45.25926	65.00087	93.05097	267.86355	40

TABLE 2

PRESENT VALUE OF AN ANNUITY OF $1

(n) Periods	2%	2½%	3%	4%	5%	6%
1	1.00000	1.00000	1.00000	1.00000	1.00000	1.00000
2	2.02000	2.02500	2.03000	2.04000	2.05000	2.06000
3	3.06040	3.07563	3.09090	3.12160	3.15250	3.18360
4	4.12161	4.15252	4.18363	4.24646	4.31013	4.37462
5	5.20404	5.25633	5.30914	5.41632	5.52563	5.63709
6	6.30812	6.38774	6.46841	6.63298	6.80191	6.97532
7	7.43428	7.54743	7.66246	7.89829	8.14201	8.39384
8	8.58297	8.73612	8.89234	9.21423	9.54911	9.89747
9	9.75463	9.95452	10.15911	10.58280	11.02656	11.49132
10	10.94972	11.20338	11.46338	12.00611	12.57789	13.18079
11	12.16872	12.48347	12.80780	13.48635	14.20679	14.97164
12	13.41209	13.79555	14.19203	15.02581	15.91713	16.86994
13	14.68033	15.14044	15.61779	16.62684	17.71298	18.88214
14	15.97394	16.51895	17.08632	18.29191	19.59863	21.01507
15	17.29342	17.93193	18.59891	20.02359	21.57856	23.27597
16	18.63929	19.38022	20.15688	21.82453	23.65749	25.67253
17	20.01207	20.86473	21.76159	23.69751	25.84037	28.21288
18	21.41231	22.38635	23.41444	25.64541	28.13238	30.90565
19	22.84056	23.94601	25.11687	27.67123	30.53900	33.75999
20	24.29737	25.54466	26.87037	29.77808	33.06595	36.78559
21	25.78332	27.18327	28.67649	31.96920	35.71925	39.99273
22	27.29898	28.86286	30.53678	34.24797	38.50521	43.39229
23	28.84496	30.58443	32.45288	36.61789	41.43048	46.99583
24	30.42186	32.34904	34.42647	39.08260	44.50200	50.81558
25	32.03030	34.15776	36.45926	41.64591	47.72710	54.86451
26	33.67091	36.01171	38.55304	44.31174	51.11345	59.15638
27	35.34432	37.91200	40.70963	47.08421	54.66913	63.70577
28	37.05121	39.85980	42.93092	49.96758	58.40258	68.52811
29	38.79223	41.85630	45.21885	52.96629	62.32271	73.63980
30	40.56808	43.90270	47.57542	56.08494	66.43885	79.05819
31	42.37944	46.00027	50.00268	59.32834	70.76079	84.80168
32	44.22703	48.15028	52.50276	62.70147	75.29883	90.88978
33	46.11157	50.35403	55.07784	66.20953	80.06377	97.34316
34	48.03380	52.61289	57.73018	69.85791	85.06696	104.18376
35	49.99448	54.92821	60.46208	73.65222	90.32031	111.43478
36	51.99437	57.30141	63.27594	77.59831	95.83632	119.12087
37	54.03425	59.73395	66.17422	81.70225	101.62814	127.26812
38	56.11494	62.22730	69.15945	85.97034	107.70955	135.90421
39	58.23724	64.78298	72.23423	90.40915	114.09502	145.05846
40	60.40198	67.40255	75.40126	95.02552	120.79977	154.76197

8%	9%	10%	11%	12%	15%	(n) Periods
1.00000	1.00000	1.00000	1.00000	1.00000	1.00000	1
2.08000	2.09000	2.10000	2.11000	2.12000	2.15000	2
3.24640	3.27810	3.31000	3.34210	3.37440	3.47250	3
4.50611	4.57313	4.64100	4.70973	4.77933	4.99338	4
5.86660	5.98471	6.10510	6.22780	6.35285	6.74238	5
7.33592	7.52334	7.71561	7.91286	8.11519	8.75374	6
8.92280	9.20044	9.48717	9.78327	10.08901	11.06680	7
10.63663	11.02847	11.43589	11.85943	12.29969	13.72682	8
12.48756	13.02104	13.57948	14.16397	14.77566	16.78584	9
14.48656	15.19293	15.93743	16.72201	17.54874	20.30372	10
16.64549	17.56029	18.53117	19.56143	20.65458	24.34928	11
18.97713	20.14072	21.38428	22.71319	24.13313	29.00167	12
21.49530	22.95339	24.52271	26.21164	28.02911	34.35192	13
24.21492	26.01919	27.97498	30.09492	32.39260	40.50471	14
27.15211	29.36092	31.77248	34.40536	37.27972	47.58041	15
30.32428	33.00340	35.94973	39.18995	42.75328	55.71747	16
33.75023	36.97371	40.54470	44.50084	48.88367	65.07509	17
37.45024	41.30134	45.59917	50.39593	55.74972	75.83636	18
41.44626	46.01846	51.15909	56.93949	63.43968	88.21181	19
45.76196	51.16012	57.27500	64.20283	72.05244	102.44358	20
50.42292	56.76453	64.00250	72.26514	81.69874	118.81012	21
55.45676	62.87334	71.40275	81.21431	92.50258	137.63164	22
60.89330	69.53194	79.54302	91.14788	104.60289	159.27638	23
66.76476	76.78981	88.49733	102.17415	118.15524	184.16784	24
73.10594	84.70090	98.34706	114.41331	133.33387	212.79302	25
79.95442	93.32398	109.18177	127.99877	150.33393	245.71197	26
87.35077	102.72314	121.09994	143.07864	169.37401	283.56877	27
95.33883	112.96822	134.20994	159.81729	190.69889	327.10408	28
103.96594	124.13536	148.63093	178.39719	214.58275	377.16969	29
113.28321	136.30754	164.49402	199.02088	241.33268	434.74515	30
123.34587	149.57522	181.94343	221.91317	271.29261	500.95692	31
134.21354	164.03699	201.13777	247.32362	304.84772	577.10046	32
145.95062	179.80032	222.25154	275.52922	342.42945	644.66553	33
158.62667	196.98234	245.47670	306.83744	384.52098	765.36535	34
172.31680	215.71076	271.02437	341.58955	431.66350	881.17016	35
187.10215	236.12472	299.12681	380.16441	484.46312	1014.34568	36
203.07032	258.37595	330.03949	422.98249	543.59869	1167.49753	37
220.31595	282.62978	364.04343	470.51056	609.83053	1343.62216	38
238.94122	309.06646	401.44778	523.26673	684.01020	1546.16549	39
259.05652	337.88245	442.59256	581.82607	767.09142	1779.09031	40

Note: Skim through this section for more annual report references

Annual Report References

Atwood Oceanics

2010 Annual Report

Note 5. Long-Term Debt

A summary of long-term debt is as follows (in thousands):

	September 30,	
	2010	*2009*
2007 credit facility, bearing interest (market adjustable) at approximately 1.1% and 1.9% per annum at September 30, 2010 and September 30, 2009, respectively	**$ 180,000**	$ 200,000
2008 credit facility, bearing interest (market adjustable) at approximately 1.8% and 2.2% per annum at September 30, 2010 and September 30, 2009, respectively	**50,000**	75,000
	$ 230,000	$ 275,000

During October 2007, we entered into a credit agreement with several banks, with Nordea Bank Finland plc, New York Branch, as Administrative Agent for the lenders, as well as Lead Arranger and Book Runner (as amended from time to time, the 2007 Credit Agreement). The 2007 Credit Agreement provides for a secured 5-year $300 million revolving loan facility with maturity in October 2012, subject to acceleration upon certain specified events of default, including but not limited to: delinquent payments, bankruptcy filings, breaches of representation or covenants, material adverse judgments, guarantees or security documents not in full effect, non-compliance with the Employee Retirement Income Security Act of 1974, defaults under other agreements including existing credit agreements, and a change in control. In addition, the 2007 Credit Agreement contains a number of limitations on our ability to: incur liens; merge, consolidate or sell assets; pay cash dividends; incur additional indebtedness; make advances, investments or loans; and transact with affiliates.

Loans under this facility bear interest at varying rates ranging from 0.70% to 1.25% over the Eurodollar Rate, depending upon the ratio of outstanding debt to earnings before interest, taxes and depreciation. The 2007 Credit Agreement supports the issuance, when required, of standby letters of credit. The collateral for the 2007 Credit Agreement consists primarily of preferred mortgages on three of our active drilling units (the Atwood Eagle, the Atwood Hunter and the Atwood Beacon). Under the 2007 Credit Agreement, we are required to pay a fee ranging from 0.225% - 0.375% per annum on the unused portion of the credit facility and certain other administrative costs. As of September 30, 2010, we have approximately $120 million of funds available to borrow under this credit facility, with standby letters of credit in the aggregate amount of approximately $0.1 million outstanding.

During November 2008, we entered into a new credit agreement with several banks with Nordea Bank Finland plc, New York Branch as Administrative Agent for the lenders, as well as Lead Arranger and Book Runner (as amended from time to time, the 2008 Credit Agreement). The 2008 Credit Agreement provides for a secured 5-year $280 million reducing revolving loan facility with maturity in November 2013, subject to acceleration upon certain specified events of default, including but not limited to: delinquent payments, bankruptcy filings, breaches of representation or covenants, material adverse judgments, guarantees or security documents not in full effect, non-compliance with the Employee Retirement Income Security Act of 1974, defaults under other agreements including existing credit agreements, such as our 2007 Credit Agreement, and a change in control. In addition, the 2008 Credit Agreement contains a number of limitations on our ability to: incur liens; merge, consolidate or sell assets; pay cash dividends; incur additional indebtedness; make advances, investments or loans; and transact with affiliates.

The 2008 Credit Agreement requires a mandatory quarterly commitment reduction of $7 million beginning at the earlier of three months after delivery of either semisubmersible drilling unit currently under construction or December 31, 2011. The commitment under this facility may be increased up to $20 million for a total commitment of $300 million. Loans under the 2008 Credit Agreement will bear interest at 1.50% over the Eurodollar Rate. The collateral for the 2008 Credit Agreement consists primarily of preferred mortgages on three of our drilling units (the Atwood Falcon, the Atwood Southern Cross, and the Atwood Aurora). Under the 2008 Credit Agreement, we are required to pay a fee of 0.75% per annum on the unused portion of the credit facility and certain other administrative costs. As of September 30, 2010, we have approximately $230 million of funds available to borrow under this credit facility, with standby letters of credit in the aggregate amount of approximately $1.4 million outstanding.

The 2008 Credit Agreement and the 2007 Credit Agreement contain various financial covenants that, among other things, require the maintenance of a leverage ratio, not to exceed 5.0 to 1.0, an interest expense coverage ratio not to be less than 2.5 to 1.0 and a required level of collateral maintenance whereby the aggregate appraised collateral value shall not be less than 150% of the total credit facility commitment. As of September 30, 2010, our leverage ratio was 0.14, our interest expense coverage ratio was 61.3 and our collateral maintenance percentage was in excess of 150%. We were in compliance with all financial covenants under the 2008 Credit Agreement and the 2007 Credit Agreement at September 30, 2010 and at all times during the year ended September 30, 2010.

Subsequent to September 30, 2010, we borrowed an additional $70 million under the 2008 Credit Agreement, bringing the total amount outstanding under that agreement to $120 million as of November 22, 2010. No additional funds have been borrowed under the 2007 Credit Agreement subsequent to September 30, 2010.

11. Debt

The carrying value of long-term debt outstanding was as follows at December 31, 2010 and 2009:

(in thousands)	*2010*	*2009*
Long-term debt:		
Senior notes:		
$500 million, 6.45% due June 1, 2016	$ 535,342	$ 540,907
$500 million, 7.20% due June 15, 2018	508,005	508,799
$300 million, 6.30% due August 1, 2018	321,622	323,862
$250 million, 8.15% due June 15, 2038	266,892	267,070
Total senior notes	1,631,861	1,640,638
Other long-term borrowings	36,988	37,528
Total long-term debt	$ 1,668,849	$ 1,678,166

Senior Notes

Our senior notes, which are unsecured, may be redeemed at our option at any time at 100% of the principal amount plus accrued interest and a specified make-whole amount. The 7.20% and 8.15% senior notes are subject to an interest rate adjustment if the debt ratings assigned to the notes are downgraded (or subsequently upgraded) and contain a change of control provision that may require us to purchase the notes under certain circumstances.

We had been parties to interest-rate swap agreements to exchange the fixed interest rate under our senior notes for a variable interest rate based on LIBOR. As a result, the carrying value of the senior notes had been adjusted to reflect changes in value caused by an increase or decrease in interest rates. During 2008, we terminated all of our swap agreements. The cumulative adjustment to the carrying value of our senior notes was $103.4 million as of the termination date which is being amortized as a reduction to interest expense over the remaining term of the senior notes, resulting in a weighted-

average effective interest rate fixed at 6.08%. The unamortized carrying value adjustment was $83.8 million as of December 31, 2010 and $92.9 million as of December 31, 2009.

Credit Agreement

In December 2010, we replaced our 5-year $1.0 billion unsecured revolving credit agreement which was set to expire in July 2011 with a 3-year $1.0 billion unsecured revolving agreement expiring December 2013. Under the new credit agreement, at our option, we can borrow on either a competitive advance basis or a revolving credit basis. The revolving credit portion bears interest at either LIBOR or the base rate plus a spread. The spread, currently 200 basis points, varies depending on our credit ratings ranging from 150 to 262.5 basis points. We also pay an annual facility fee regardless of utilization. This facility fee, currently 37.5 basis points, may fluctuate between 25 and 62.5 basis points, depending upon our credit ratings. The competitive advance portion of any borrowings will bear interest at market rates prevailing at the time of borrowing on either a fixed rate or a floating rate based on LIBOR, at our option.

The terms of the new credit agreement include standard provisions related to conditions of borrowing, including a customary material adverse event clause which could limit our ability to borrow additional funds. In addition, the credit agreement contains customary restrictive and financial covenants as well as customary events of default, including financial covenants regarding the maintenance of a minimum level of net worth of $5,257.9 million at December 31, 2010 and a maximum leverage ratio of 3.0:1. We are in compliance with the financial covenants, with actual net worth of $6,924.1 million and a leverage ratio of 0.8:1, as measured in accordance with the credit agreement as of December 31, 2010. In addition, the new credit agreement includes an uncommitted $250 million incremental loan facility.

At December 31, 2010, we had no borrowings outstanding under the credit agreement. We have outstanding letters of credit of $10.4 million secured under the credit agreement. No amounts have ever been drawn on these letters of credit. Accordingly, as of December 31, 2010, we had $989.6 million of remaining borrowing capacity under the credit agreement, none of which would be restricted by our financial covenant compliance requirement. We have other customary, arms-length relationships, including financial advisory and banking, with some parties to the credit agreement.

Other Long-Term Borrowings

Other long-term borrowings of $37.0 million at December 31, 2010 represent junior subordinated debt of $36.1 million and financing for the renovation of a building of $0.9 million. The junior subordinated debt, which is due in 2037, may be called by us without penalty in 2012 and bears a fixed annual interest rate of 8.02% payable quarterly until 2012, and then payable at a floating rate based on LIBOR plus 310 basis points. The debt associated with the building renovation bears interest at 2.00%, is collateralized by the building, and is payable in various installments through 2014.

Note 7—Debt

Long-Term Debt

	Due Date	*2008*	*2007*	*2006*
7.375% Debentures	2027	$137,047	$137,044	$137,041
7.45% Debentures	2097	146,967	146,960	146,954
1.0% to 13.5%	Through 2015			
Promissory Notes		19,713	9,450	7,881
		$303,727	$293,454	$291,876

Maturities of long-term debt are as follows for the next five years: $13,570 in 2009; $8,904 in 2010; $8,537 in 2011; $401 in 2012 and $402 in 2013. Interest expense on long-term debt was $31,973, $39,272, and $40,552 for 2008, 2007 and 2006, respectively.

Among other restrictions, the Company's Notes, Debentures and revolving credit agreement contain certain covenants relating to liens, ratings changes, merger and sale of assets, consolidated leverage and change of control as defined in the agreements. In the event of default under any one of these arrangements, acceleration of the maturity of any one or more of these borrowings may result. The Company was in compliance with all covenants for all years presented.

On October 6, 1997, the Company issued $50,000 of debt securities consisting of 5.5% notes, due October 15, 2027, with provisions that the holders, individually or in the aggregate, may exercise a put option that would require the Company to repay the securities. Prior to 2006, individual debt security holders exercised put options on $46,905 of these debt securities. During 2006, additional put options were exercised on $2,995 of these debt securities. Put options on the remaining balance of $100 of these debt securities were exercised in 2008.

Effective December 24, 1997, the Company filed a shelf registration with the Securities and Exchange Commission (SEC) covering $150,000 of unsecured debt securities with maturities greater than nine months from the date of issue. Effective September 8, 1998, the Company filed a universal shelf registration statement with the SEC to issue debt securities, common stock and warrants up to $1,500,000. Both shelf registrations expired in December 2008. There were no borrowings outstanding or issuance of common stock or warrants under either registration during all years presented.

Short-term borrowings. At December 31, 2008, 2007 and 2006, borrowings outstanding under the domestic commercial paper program totaled $83,064, $299,191 and $338,805, respectively, and were included in Short-term borrowings. The weighted-average interest rate related to these borrowings was 2.6%, 5.5% and 5.5% at December 31, 2008, 2007 and 2006, respectively. Borrowings outstanding under various foreign programs at December 31, 2008 of $33,374 with a weighted-average interest rate of 9.5%, December 31, 2007 of $107,891 with a weighted-average interest rate of 8.9% and December 31, 2006 of $30,973 with a weighted-average interest rate of 4.7% were included in Short-term borrowings.

On April 17, 2006, the Company entered into a three-year credit agreement, which was amended on April 25, 2006 and May 8, 2006. This credit agreement gives the Company the right to borrow and to obtain the issuance, renewal, extension and increase of a letter of credit up to an aggregate availability of $250,000. On May 23, 2006, the Company entered into a five-year credit agreement, which was amended on July 24, 2006. This credit agreement gives the Company the right to borrow and to obtain the issuance, renewal, extension and increase of a letter of credit up to an aggregate availability of $250,000. On April 26, 2007 and on August 28, 2007, which was amended on September 17, 2007 and September 25, 2007, the Company entered into two additional five-year credit agreements. This additional credit gives the Company the right to borrow and to obtain the issuance, renewal, extension and increase of a letter of credit up to an aggregate availability of $500,000. The total credit agreements aggregate $1,000,000. At December 31, 2008, $400,000 of this amount was outstanding, with a weighted-average interest rate of 2.8%. At December 31, 2007, $250,000 of this amount was outstanding, with a weighted average interest rate of 5.0%. At December 31, 2006, there were no borrowings outstanding under any of these credit agreements.

The Company has a five-year senior unsecured revolving credit agreement. The agreement was amended in 2008 to extend the maturity date from July 20, 2009 to July 20, 2010. A $500,000 letter of credit subfacility amendment to the agreement was reduced to $300,000 in 2008. The Company uses the revolving credit agreement primarily to satisfy its commercial paper program's dollar for dollar liquidity requirement. The Company's commercial paper program maximum borrowing capability is $910,000. The maximum borrowing capability will be reduced to $845,000 effective July 20, 2009. There were no borrowings outstanding under the revolving credit agreement during all years presented.

On February 1, 2006, the Company sold or contributed certain of its accounts receivable to SWC Receivables Funding LLC (SWC), a consolidated wholly-owned subsidiary. SWC entered into an accounts receivable securitization borrowing facility with a third party program agent. Under this program, SWC could borrow up to $500,000 and secure such borrowings by granting a security interest in certain eligible accounts receivable and related security. At December 31, 2007 and 2006, SWC had no borrowings outstanding under this program. On July 11, 2008, SWC terminated the accounts receivable securitization borrowing facility with a third party program agent and SWC was dissolved. There were no outstanding borrowings under the facility at the time it was terminated and no termination penalties were incurred.

Note 8. Other Long-Term Liabilities

The operations of the Company, like those of other companies in our industry, are subject to various federal, state and local environmental laws and regulations. These laws and regulations not only govern current operations and products, but also impose potential liability on the Company for past operations. Management expects environmental laws and regulations to impose increasingly stringent requirements upon the Company and the industry in the future. Management believes that the Company conducts its operations in compliance with applicable environmental laws and regulations and has implemented various programs designed to protect the environment and promote continued compliance.

The Company is involved with environmental investigation and remediation activities at some of its current and former sites (including sites which were previously owned and/or operated by businesses acquired by the Company). In addition, the Company, together with other parties, has been designated a potentially responsible party under federal and state environmental protection laws for the investigation and remediation of environmental contamination and hazardous waste at a number of third-party sites, primarily Superfund sites. In general, these laws provide that potentially responsible parties may be held jointly and severally liable for investigation and remediation costs regardless of fault. The Company may be similarly designated with respect to additional third-party sites in the future.

The Company initially provides for estimated costs of environmental-related activities relating to its past operations and third-party sites for which commitments or clean-up plans have been developed and when such costs can be reasonably estimated based on industry standards and historical experience. These estimated costs are determined based on currently available facts regarding each site. If the best estimate of costs can only be identified as a range and no specific amount within that range can be determined more likely than any other amount within the range, the minimum of the range is provided. At December 31, 2008, the aggregate unaccrued maximum of the estimated range of possible outcomes is $114,927 higher than the minimum.

The Company continuously assesses its potential liability for investigation and remediation-related activities and adjusts its environmental-related accruals as information becomes available upon which more accurate costs can be reasonably estimated and as additional accounting guidelines are issued. Actual costs incurred may vary from these estimates due to the inherent uncertainties involved including, among others, the number and financial condition of parties involved with respect to any given site, the volumetric contribution which may be attributed to the Company relative to that attributed to other parties, the nature and magnitude of the wastes involved, the various technologies that can be used for remediation and the determination of acceptable remediation with respect to a particular site.

Included in Other long-term liabilities at December 31, 2008, 2007, and 2006 were accruals for extended environmental-related activities of $128,179, $133,333 and $133,610, respectively. Estimated costs of current investigation and remediation activities of $52,555, $60,447 and $39,529 were included in Other accruals at December 31, 2008, 2007 and 2006, respectively.

Five of the Company's currently and formerly owned manufacturing sites accounted for the majority of the accrual for environmental-related activities and the unaccrued maximum of the estimated range of possible outcomes at December 31, 2008. At December 31, 2008, $135,161, or 74.8 percent of the total accrual, related directly to these five sites. In the aggregate unaccrued maximum of $114,927 at December 31, 2008, $74,944, or 65.2 percent, related to the five manufacturing sites. While environmental investigations and remedial actions are in different stages at these sites, additional investigations, remedial actions and monitoring will likely be required at each site.

Management cannot presently estimate the ultimate potential loss contingencies related to these sites or other less significant sites until such time as a substantial portion of the investigation at the sites is completed and remedial action plans are developed. In the event any future loss contingency significantly exceeds the current amount accrued, the recording of the ultimate liability may result in a material impact on net income for the annual or interim period during which the additional costs are accrued. Management does not believe that any potential liability ultimately attributed to the Company for its environmental-related matters will have a material adverse effect on the Company's financial condition, liquidity, or cash flow due to the extended period of time during which environmental investigation and remediation takes place. An estimate of the potential impact on the Company's operations cannot be made due to the aforementioned uncertainties.

Management expects these contingent environmental related liabilities to be resolved over an extended period of time. Management is unable to provide a more specific time frame due to the indefinite amount of time to conduct investigation activities at any site, the indefinite amount of time to obtain environmental agency approval, as necessary, with respect to investigation and remediation activities, and the indefinite amount of time necessary to conduct remediation activities.

FIN No. 47, “Accounting for Conditional Asset Retirement Obligations—an Interpretation of FASB Statement No. 143,” requires a liability be recognized for the fair value of a conditional asset retirement obligation if a settlement date and fair value can be reasonably estimated. The Company recognizes a liability for any conditional asset retirement obligation when sufficient information is available to reasonably estimate a settlement date to determine the fair value of such a liability. The Company has identified certain conditional asset retirement obligations at various current and closed manufacturing, distribution and store facilities. These obligations relate primarily to asbestos abatement, hazardous waste Resource Conservation and Recovery Act (RCRA) closures, well abandonment, transformers and used oil disposals and underground storage tank closures. Using investigative, remediation and disposal methods that are currently available to the Company, the estimated costs of these obligations were accrued and are not significant. The recording of additional liabilities for future conditional asset retirement obligations may result in a material impact on net income for the annual or interim period during which the costs are accrued. Management does not believe that any potential liability ultimately attributed to the Company for its conditional asset retirement obligations will have a material adverse effect on the Company's financial condition, liquidity, or cash flow due to the extended period of time over which sufficient information may become available regarding the closure or modification of any one or group of the Company's facilities. An estimate of the potential impact on the Company's operations cannot be made due to the aforementioned uncertainties.

Note 8. Borrowings and Lines of Credit

Short-term borrowings consist of the following:

(in millions of dollars)	*2007*	*2006*
Domestic borrowings	$ 1	$ 6
Foreign bank borrowings	1,084	401
Commercial paper	-	450
	$1,085	$857

The weighted-average interest rates applicable to short-term borrowings outstanding at December 31, 2007 and 2006 were 7.2% and 5.9%, respectively. At December 31, 2007, approximately $2.0 billion was available under short-term lines of credit with local banks at our various domestic and international subsidiaries.

At December 31, 2007, we had credit commitments from banks totaling $2.5 billion. We had a credit commitment of $1.5 billion under a revolving credit agreement, which serves as a backup facility for the issuance of commercial paper. As of December 31, 2007, there were no borrowings under this revolving credit agreement. We also have a $1.0 billion multi-currency revolving credit agreement that is to be used for general corporate funding purposes, including acquisitions. As of December 31, 2007, approximately $503 million had been borrowed under this revolving credit agreement to fund corporate expenses and international acquisitions. This credit agreement expires November 2011.

In December 2007, we issued $1.0 billion of long-term debt, the proceeds of which were primarily used to repay commercial paper borrowings. We generally use our commercial paper borrowings for general corporate purposes including financing acquisitions and the repurchase of our stock. The terms of the long term debt issued in December 2007 were as follows:

Principal (in millions of dollars)	*Rate*	*Maturity*
$1,000	5.375%	December 15, 2017

We may redeem the notes, in whole or in part, at our option at any time at a redemption price in U.S. dollars equal to the greater of 100% of the principal amount of the notes to be redeemed or the sum of the present values of the remaining scheduled payments of principal and interest on the notes to be redeemed, discounted to the redemption date on a semiannual basis at the adjusted treasury rate plus 25 basis points. The redemption price will also include interest accrued to the date of redemption on the principal balance of the notes being redeemed.

In May 2006, we issued $1.1 billion of long-term debt, the proceeds of which were used to repay commercial paper borrowings. The long-term debt issued in May 2006 is comprised of two series of notes as follows:

Principal (in millions of dollars)	*Rate*	*Maturity*
$600	6.05%	June 1, 2036
$500	LIBOR + .07%	June 1, 2009

We may redeem the notes due in 2009, in whole or in part, at any time at a redemption price in U.S. dollars equal to 100% of the principal amount, plus interest accrued. We may redeem the notes due in 2036, in whole or in part, at our option at any time, at a redemption price in U.S. dollars equal to the greater of 100% of the principal amount of the notes to be redeemed or the sum of the present values of the remaining scheduled payments of principal and interest on the notes to be redeemed, discounted to the redemption date on a semiannual basis at the adjusted treasury rate plus 15 basis points. The redemption price will also include interest accrued to the date of redemption on the principal balance of the notes being redeemed. The three month LIBOR rate as of December 31, 2007 was approximately 4.7%.

In April 2005, we issued $2.4 billion of long-term debt, the proceeds of which were used primarily to support the funding of the Kidde acquisition. The long-term debt is comprised of three series of notes as follows:

Principal (in millions of dollars)	*Rate*	*Maturity*
$ 600	4.375%	May 1, 2010
$1,200	4.875%	May 1, 2015
$ 600	5.400%	May 1, 2035

We may redeem the notes of any series, in whole or in part, at our option at any time, at a redemption price in U.S. dollars equal to the greater of 100% of the principal amount of the notes of the series to be redeemed or the sum of the present values of the remaining scheduled payments of principal and interest on the notes of the series to be redeemed as described below, discounted to the redemption date on a semiannual basis, at the adjusted treasury rate described below plus 10 basis points for the 4.375% notes, 15 basis points for the 4.875% notes and 15 basis points for the 5.400% notes. In each case, the redemption price will also include interest accrued to the date of redemption on the principal balance of the notes being redeemed.

Total long-term debt consists of the following:

(in millions of dollars)	*Weighted-Average Interest Rate*	*Maturity*	*2007*	*2006*
Notes and other debt denominated in:				
U.S. dollars	6.0%	2008-2036	$7,942	$6,947
Foreign currency	5.7%	2008-2019	56	29
ESOP debt	7.7%	2008-2009	65	98
			8,063	7,074
Less: Long-term debt currently due		48	37	
			$8,015	$7,037

Principal payments required on long-term debt for the next five years are: $48 million in 2008, $953 million in 2009, $1,123 million in 2010, $538 million in 2011, and $504 million in 2012.

In July 2007, we replaced our existing shelf registration statement by filing with the SEC a universal shelf registration statement for an indeterminate amount of securities for future issuance, subject to our internal limitations on the amount of debt to be issued under this shelf. As of December 31, 2007, we had issued $1.0 billion of long-term debt under this shelf registration statement.

The percentage of total debt at floating interest rates was 18% and 17% at December 31, 2007 and 2006, respectively.

7. Debt

A summary of debt follows:

	2007	*2006*
Term B loan due 2010[a]	$261.0	$375.0
6.60% notes due 2027	15.9	100.0
11.125% senior notes due 2007	-	16.1
6.75% senior notes due 2029[b]	250.0	250.0
8% convertible subordinated debentures due 2010[c]	2.3	2.4
6.5% junior subordinated deferrable interest debentures due 2029[d]	215.1	214.1
Term loans at rates ranging from 5.814% to 7.2978% due in varying amounts through 2011[e]	49.9	28.1
Other	1.8	9.8
	796.0	995.5
Less: Current debt obligations	33.7	35.8
Long term debt	762.3	959.7

[a] The term loan, a component of the Company's Senior Credit Facility, matures on October 8, 2010 and bears interest at LIBOR + 1.50%, with the Company holding the option to reset interest rates for one, two, three or six month periods. The weighted average rate was 6.71% as of December 31, 2007. The Senior Credit Facility is also comprised of a $150 million committed revolving credit facility (the "Revolving Facility") which matures on April 8, 2009. The Senior Credit Facility is secured by liens on the Company's assets (including real, personal and intellectual properties) and is guaranteed by substantially all of the Company's current and future wholly-owned domestic subsidiaries (see Note 25).

As of December 31, 2007, the Company had $47.9 million of outstanding letters of credit under the Revolving Facility. The remaining $102.1 million was available for use. The Company's Senior Credit Facility requires quarterly compliance with certain financial covenants, including a leverage ratio and an interest coverage ratio, and established limitations on the permitted amount of capital expenditures and dividends.

[b] The senior notes are guaranteed by each of Hercules' current and future wholly-owned domestic restricted subsidiaries.

[c] The convertible subordinated debentures are convertible into common stock at $14.90 per share and are redeemable at the option of the Company at varying rates.

[d] The 6.5% junior subordinated deferrable interest debentures due 2029 (the "6.5% debentures") had an initial issue price of $741.46 and have a redemption price of $1,000. The 6.5% debentures were initially issued to Hercules Trust II ("Trust II"), a subsidiary trust established in 1999. Trust II had issued, in an underwritten public offering, 350,000 CRESTS[SM] Units, each consisting of a 6.5% preferred security of Trust II and a warrant (exercisable through 2029) to purchase 23.4192 shares of the Company's common stock for the equivalent of $42.70 per share. The preferred securities and the warrants were separable and were initially valued at $741.46 and $258.54, respectively. The Company and Trust II

accreted the difference between the initial valuation of the 6.5% debentures and the preferred securities and the redemption value of $1,000 over the term of the 6.5% debentures and the preferred securities. In connection with the Company's dissolution and liquidation of Trust II in December 2004, Trust II distributed the 6.5% debentures to the holders of the preferred securities and the preferred securities were cancelled. The CRESTS[SM] Units now consist of the 6.5% debentures and the warrants.

[(e)] Includes loans issued by Hercules Tianpu for which Hercules has provided a guarantee for 55% of the outstanding balances. The loans are denominated in renminbi and U.S. Dollar-equivalents and include a short-term loan payable due in 2008 for approximately $17.2 million and a long-term loan payable due in 2011 for approximately $25.2 million.

At December 31, 2007, Hercules had available and unused foreign lines of credit totaling $35.1 million and $31.0 million, respectively.

Debt maturities are $33.7 million in 2008, $12.2 million in 2009, $263.1 million in 2010, $6.1 million in 2011 and $480.9 million thereafter.

Total interest expense incurred for the years ended December 31, 2007, 2006 and 2005 was $69.7 million, $71.5 million and $89.8 million, respectively. The total amounts capitalized for the aforementioned periods were $1.1 million, $0.3 million and $0.4 million, respectively.

6. Debt

Short-term debt consists of the following (in millions):

	September 30,	
	2004	**2003**
Current portion of long-term debt	-	$8.4
Other borrowings	0.2	0.3
Short-term debt	$0.2	$8.7

Long-term debt consists of the following (in millions):

	September 30,	
	2004	**2003**
6.15% notes, payable in 2008	$353.7	$360.4
6.70% debentures, payable in 2028	250.0	250.0
5.20% debentures, payable in 2098	200.0	200.0
Other borrowings	-	8.4
Unamortized discount	(46.0)	(46.4)
Total	757.7	772.4
Less current portion		
	-	8.4
Long-term debt	$757.7	$764.0

In September 2002, we entered into an interest rate swap contract (the Swap) that effectively converted our $350.0 million aggregate principal amount of 6.15% notes, payable in 2008, to floating rate debt based on six-month LIBOR. The floating rate was 4.27 percent at September 30, 2004 and 3.52 percent at September 30, 2003. The fair value of the Swap, based upon quoted market prices for contracts with similar maturities, was $3.7 million at September 30, 2004 and $10.4 million at September 30, 2003. As permitted by SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), as amended, we have designated the Swap as a fair value hedge. Accordingly, the fair value of the Swap was recorded in other assets on the Consolidated Balance Sheet at September 30, 2004 and 2003. The carrying value of the underlying debt was increased to $353.7 million at September 30, 2004 and $360.4 million at September 30, 2003 in accordance with SFAS 133.

At September 30, 2004, we had $675.0 million of unsecured committed credit facilities, with $337.5 million expiring in October 2004 and $337.5 million expiring in October 2005. These facilities were available for general corporate purposes, including support for our commercial paper borrowings. On October 26, 2004, we entered into a new five-year $600.0 million unsecured revolving credit facility. It replaced both the facility expiring on that date and the facility expiring in October 2005 (which we cancelled on that date). Borrowings under our new credit facility bear interest based on short-term money market rates in effect during the period such borrowings are outstanding. The terms of our credit facility contain a covenant under which we would be in default if our debt to capital ratio were to exceed 60 percent. In addition to our $600.0 million credit facility, short-term unsecured credit facilities available to foreign subsidiaries amounted to $130.4 million at September 30, 2004. There were no significant commitment fees or compensating balance requirements under any of our credit facilities.

Interest payments were $40.9 million during 2004, $54.7 million during 2003, and $63.1 million during 2002.

10. Other Liabilities

Other accrued liabilities follow (in millions):		
	December 31,	
	2004	*2003*
Current liabilities:		
Wages and employee benefits	$291	$238
Asbestos settlement	315	282
Income taxes	153	88
Other current liabilities	417	466
Other accrued liabilities	$1,176	$1,074
Non-current liabilities:		
Asbestos settlement	$144	$136
Customer deposits	197	
Other non-current liabilities	374	276
Other liabilities	$715	$412

Asbestos Settlement

The current liability represents the cost of our investment in PCE and the fair value of the 25 million shares of Corning common stock as of December 31, 2004, which will be contributed to the Plan when it becomes effective. As the timing of this obligation's settlement is controlled by a third party (not Corning), this portion of the PCC liability is considered a “due on demand” obligation. Accordingly, this portion of the obligation has been classified as a current liability, even though it is possible that the contribution could be made in 2006 or later. The non-current liability represents the net present value of cash payments as of December 31, 2004, which will be contributed to the Plan in six installments beginning one year after the Plan is effective. Refer to Note 7 (Investments) for additional information on the asbestos settlement.

Customer Deposits

During 2004, in response to the rapid growth of the liquid crystal display (LCD) market, Corning held discussions with several of its customers to discuss how to meet this demand. Corning and these

customers have typically entered into multi-year supply agreements for the purchase and sale of glass substrates. These agreements provide for Corning to supply a percentage of the customers' requirements and include mechanisms for forecasting and ordering. As part of its discussions, Corning has sought improved payment terms, including deposits against orders, to provide a greater degree of assurance that we are effectively building capacity to meet the needs of a rapidly growing industry.

In 2004, Corning and a Taiwanese customer entered into a long-term purchase and supply agreement (as amended) in which the Display Technologies segment will supply LCD glass to the customer over a five-year period. As part of the agreement, the customer will make advance cash deposits of $460 million to Corning through 2006 for a portion of the contracted glass to be purchased. Corning received a total of $204 million of deposits against orders in 2004 and expects to receive an additional $171 million in 2005.

In the event the customer does not make all customer deposit installment payments or elects not to purchase the agreed upon quantities of product, subject to specific conditions outlined in the agreement, Corning may retain certain amounts of the customer deposit. Likewise, if Corning does not deliver agreed upon product quantities, subject to specific conditions outlined in the agreement, Corning may be required to return certain amounts of the customer deposit.

11. Debt

(In millions):		
	December 31,	
	2004	*2003*
Short-term borrowings, including current portion of long-term debt		$ 26
Short-term borrowings		
Current portion of long-term debt	**$ 478**	120
Total	**$ 478**	$ 146

(In millions):		
	December 31,	
	2004	*2003*
Long-term debt		
Euro notes, 5.625%, due 2005	**$ 189**	$ 173
Debentures, 7%, due 2007, net of unamortized discount of $15 million in 2004 and $20 million in 2003	**85**	80
Convertible notes, 4.875%, due 2008	**96**	96

Convertible debentures, 3.50%, due 2008	**297**	665
Notes, 6.3%, due 2009	**150**	150
Euro notes, 6.25%, due 2010	**408**	374
Debentures, 6.75%, due 2013	**100**	100
Debentures, 5.90%, due 2014	**200**	
Zero coupon convertible debentures, 2%, due 2015, redeemable and callable in 2005	**272**	385
Debentures, 6.20%, due 2016	**200**	
Debentures, 8.875%, due 2016	**81**	82
Debentures, 8.875%, due 2021	**82**	83
Debentures, 7.625%, due 2024	**1**	100
Medium-term notes, average rate 8.1%, due through 2025	**175**	178
Debentures, 6.85%, due 2029	**150**	150
Other, average rate 3.4%, due through 2015	**206**	172
Total long-term debt	**2,692**	2,788
Less current portion of long-term debt	**478**	120
Long-term debt	**$2,214**	$2,668

Based on borrowing rates currently available to us for loans with similar terms and maturities, the fair value of long-term debt was $2.8 billion at December 31, 2004.

The following table shows debt maturities by year at December 31, 2004 (in millions):

2005	*2006*	*2007*	*2008*	*2009*	*Thereafter*
$478	$16	$104	$411	$166	$1,517

We have convertible debt of $297 million due November 1, 2008 that is convertible into approximately 31 million shares of common stock at an effective conversion price of $9.675 per share. The debentures are available for conversion into 103.3592 shares of Corning common stock for each $1,000 debenture. The debentures are issued at par and pay interest of 3.5% semi-annually on May 1 and November 1 of each year. Effective November 8, 2004, we may call the debentures at any time, at specified redemption prices. The holder can convert the debenture into Corning common stock at any time prior to maturity or redemption.

We have $272 million of zero coupon convertible debentures outstanding. The initial price of the debentures was $741.92 with a 2% annual yield. Interest is compounded semi-annually with a 25%

conversion factor. The debentures mature on November 8, 2015, and are convertible into approximately 3 million shares of Corning common stock at the rate of 8.3304 shares per $1,000 debenture. We may call the debentures at any time on or after November 8, 2005. The debentures may be put to us for $819.54 on November 8, 2005 and $905.29 on November 8, 2010. We have the option of settling this obligation in cash, common stock, or a combination of both. The holder can convert the debenture into Corning common stock at any time prior to maturity or redemption. The zero coupon convertible debentures are presented in the above table as due in 2005 which is the earliest possible redemption date.

We also have $96 million of convertible subordinated notes bearing interest at 4.875%, due in 2008. The notes are convertible into 6 million shares of Corning common stock at a conversion price of approximately $16 per share.

We have full access to a $2.0 billion revolving line of credit with a syndicate of banks. The line of credit expires in August 2005. There were no borrowings under the agreement at December 31, 2004. The revolving credit agreement provides for borrowing of U.S. dollars and Euro currency at various rates and supports our commercial paper program when available. The facility includes a covenant requiring us to maintain a total debt to total capital ratio, as defined, not greater than 60%. At December 31, 2004, this ratio was 41%.

Debt Retirements

During the years ended December 31, 2004, 2003, and 2002, we retired a significant portion of our outstanding debentures as part of a debt reduction program. The debt was retired through a combination of cash repurchases and exchanges for Corning common stock. The following table summarizes the activities related to our debt retirements (in millions):

	Book Value of Debentures Retired	*Cash Paid*	*Shares Issued*	*Gain (Loss)*
2004 activity:				
Convertible debentures, 3.5%, due 2008	**$368**	**$37**	**38**	**$(36)**
Zero coupon convertible debentures, 2%, due 2015	**119**	**117**		
Total 2004 activity	**$487**	**$154**	**38**	**$(36)**
2003 activity:				
Zero coupon convertible debentures, 2%, due 2015	$1,239	$1,121	6	$20
Euro notes, 5.625%, due 2005	67	68		(1)
Total 2003 activity	$1,306	$1,189	6	$19

2002 activity:			
Zero coupon convertible debentures, 2%, due 2015	$493	$308	$175
Euro notes, 5.625%, due 2005	1	1	1
Total 2002 activity	$494	$309	$176

In addition to the above repurchases, during 2004 we repaid approximately $99 million of our 7.625% debentures as a result of certain bond holders exercising their early repayment option. The remaining balance of the bonds that were not repaid will mature in 2024.

Kimberly Clark

2004 Annual Report

Note 4. Debt

Long-term debt is composed of the following:

	Weighted-Average Interest Rate	*Maturities*	*December 31*	
			2004	*2003*
			(Millions of dollars)	
Notes and debentures	5.77%	2005-2038	$2,309.8	$2,342.9
Industrial development revenue bonds	2.58%	2006-2037	300.7	381.3
Bank loans and other financings in various currencies	7.22%	2005-2031	272.9	194.9
Total long-term debt			2,883.4	2,919.1
Less current portion			585.4	185.4
Long-term portion			$2,298.0	$2,733.7

Fair value of total long-term debt, based on quoted market prices for the same or similar debt issues, was approximately $3.0 billion and $3.1 billion at December 31, 2004 and 2003, respectively. Scheduled maturities of long-term debt for the next five years are $585.4 million in 2005, $64.8 million in 2006, $336.7 million in 2007, $19.7 million in 2008 and $5.1 million in 2009.

At December 31, 2004, the Corporation had $1.2 billion of revolving credit facilities. These facilities, unused at December 31, 2004, permit borrowing at competitive interest rates and are available for general corporate purposes, including backup for commercial paper borrowings. The Corporation pays commitment fees on the unused portion but may cancel the facilities without penalty at any time prior to their expiration. Of these facilities, $600 million expires in September 2005 and the balance expires in November 2009.

Debt payable within one year is as follows:

	December 31	
	2004	*2003*
	(Millions of dollars)	
Commercial paper	**$ 526.3**	$533.5
Current portion of long-term debt	**585.4**	185.4
Other short-term debt	**103.0**	145.4
Total	**$1,214.7**	$864.3

At December 31, 2004 and 2003, the weighted-average interest rate for commercial paper was 2.3 percent and 1.0 percent, respectively.

Lockheed Martin

2002 Annual Report

Note 9—Debt

The Corporation's long-term debt is primarily in the form of publicly issued, fixedrate notes and debentures, summarized as follows:

Type (Maturity Dates) (In millions, except interest rate data)	*Range of Interest Rates*	***2002***[(a)]	*2001*
Notes (2003-2022)	6.5-9.0%	**$3,099**	$3,114
Debentures (2011-2036)	7.0-9.1%	**4,198**	4,198
ESOP obligations (2003-2004)	8.4%	**82**	132
Other obligations (2003-2016)	1.0-10.5%	**178**	67
		7,557	7,511

Less current maturities	**(1,365)**	(89)	
		$6,192	$7,422

[a] Amounts exclude a $25 million adjustment to the fair value of long-term debt relating to the Corporation's interest rate swap agreements which will not be settled in cash.

In 2003, the Corporation decided to issue irrevocable redemption notices to the trustees for two issuances of callable debentures totaling $450 million. One notice was for $300 million of 7.875% debentures due on March 15, 2023, which were callable on or after March 15, 2003. The second was for $150 million of 7.75% debentures due on April 15, 2023, which were callable on or after April 15, 2003. The Corporation expects to repay amounts due on March 15, 2003 and April 15, 2003, respectively. Therefore, the $450 million of debentures to be redeemed has been included in current maturities of long-term debt on the consolidated balance sheet at December 31, 2002. The Corporation expects to incur a loss on the early repayment of the debt, net of state income tax benefits, of approximately $16 million, or $10 million after tax.

In the fourth quarter of 2002, the Corporation recorded $150 million of debt related to its guarantee of certain borrowings of Space Imaging (see Note 8). The debt was recorded due to the Corporation's assessment regarding Space Imaging's inability to attract the necessary funding sufficient to repay the borrowings, which are due on March 30, 2003. The debt is included in other obligations above and has been classified as current maturities of long-term debt in the Corporation's consolidated balance sheet.

In September 2001, the Corporation redeemed approximately $117 million of 7% debentures ($175 million at face value) due in 2011 which were originally sold at approximately 54% of their principal amount. The debentures were redeemed at face value, resulting in an unusual loss, net of state income tax benefits, of $55 million which was included in other income and expenses. The loss reduced net earnings by $36 million ($0.08 per diluted share).

In July 2001, COMSAT, a wholly-owned subsidiary of the Corporation, redeemed $200 million in principal amount of the 8.125% Cumulative Monthly Income Preferred Securities (MIPS) previously issued by a wholly-owned subsidiary of COMSAT. The MIPS were redeemed at par value of $25 per share plus accrued and unpaid dividends to the redemption date. The redemption did not result in an unusual gain or loss on the early repayment of debt.

Also in 2001, the Corporation repaid approximately $1.26 billion of notes outstanding which had been issued to a wholly-owned subsidiary of General Electric Company. The notes would have been due November 17, 2002. The early repayment of the notes did not result in an unusual gain or loss on the early repayment of debt.

In December 2000, the Corporation purchased approximately $1.9 billion in principal amount of debt securities included in tender offers for six issues of notes and debentures. The repurchase of the debt

securities resulted in a loss, net of income tax benefits, of $156 million which was included in other income and expenses. The loss reduced net earnings by $95 million ($0.24 per diluted share).

The Corporation has entered into interest rate swaps toswap fixed interest rates on approximately $920 million of its long-term debt for variable interest rates based on LIBOR. At December 31, 2002, the fair values of interest rate swap agreements outstanding, as well as the amounts of gains and losses recorded during the year, were not material.

The registered holders of $300 million of 40 year debentures issued in 1996 may elect, between March 1 and April 1, 2008, to have their debentures repaid by the Corporation on May 1, 2008.

A leveraged employee stock ownership plan (ESOP) incorporated into the Corporation's salaried savings plan borrowed $500 million through a private placement of notes in 1989. These notes are being repaid in quarterly installments over terms ending in 2004. The ESOP note agreement stipulates that, in the event that the ratings assigned to the Corporation's long-term senior unsecured debt are below investment grade, holders of the notes may require the Corporation to purchase the notes and pay accrued interest.

These notes are obligations of the ESOP but are guaranteed by the Corporation and included as debt in the Corporation's consolidated balance sheet.

At December 31, 2002, the Corporation had in place a $1.5 billion revolving credit facility; no borrowings were outstanding. This credit facility will expire in November 2006. Borrowings under the credit facility would be unsecured and bear interest at rates based, at the Corporation's option, on the Eurodollar rate or a bank Base Rate (as defined). Each bank's obligation to make loans under the credit facility is subject to, among other things, the Corporation's compliance with various representations, warranties and covenants, including covenants limiting the ability of the Corporation and certain of its subsidiaries to encumber assets and a covenant not to exceed a maximum leverage ratio. In October 2002, the Corporation terminated its $1.0 billion 1-year credit facility.

The Corporation's long-term debt maturities for the five years following December 31, 2002 are: $1,365 million in 2003; $141 million in 2004; $15 million in 2005; $783 million in 2006; $33 million in 2007; and $5,220 million thereafter.

Certain of the Corporation's other financing agreements contain restrictive covenants relating to debt, limitations on encumbrances and sale and lease-back transactions, and provisions which relate to certain changes in control.

The estimated fair values of the Corporation's long-term debt instruments at December 31, 2002, aggregated approximately $9.0 billion, compared with a carrying amount of approximately $7.6 billion. The fair values were estimated based on quoted market prices for those instruments that are publicly traded. For privately placed debt, the fair values were estimated based on the quoted market prices for similar issues, or on current rates offered to the Corporation for debt with similar remaining maturities.

Unless otherwise indicated elsewhere in the notes to the financial statements, the carrying values of the Corporation's other financial instruments approximate their fair values.

In June 2000, the Corporation paid $207 million to settle its share of obligations of Globalstar, L.P. (Globalstar) under a revolving credit agreement on which Lockheed Martin was a partial guarantor. At the same time, Loral Space, under a separate indemnification agreement between the Corporation and Loral Space, paid Lockheed Martin $57 million. In light of the uncertainty of the Corporation recovering the amounts paid on Globalstar's behalf from Globalstar, the Corporation recorded an unusual charge in the second quarter of 2000, net of state income tax benefits, of approximately $141 million in other income and expenses. The charge reduced net earnings for 2000 by $91 million ($0.23 per diluted share).

Interest payments were $586 million in 2002, $707 million in 2001 and $947 million in 2000.

Applied Materials

2002 Annual Report

Note 4—Notes Payable

Applied has credit facilities for unsecured borrowings in various currencies up to approximately $666 million, of which $500 million is comprised of two revolving credit agreements in the U.S. with a group of banks. Both agreements expire in March 2003. The agreements provide for borrowings at various rates, including the lead bank's prime reference rate, and include financial and other covenants with which Applied was in compliance at October 27, 2002. No amounts were outstanding under these agreements at the end of fiscal 2001 or 2002. The remaining credit facilities of approximately $166 million are primarily with Japanese banks at rates indexed to their prime reference rate. No amounts were outstanding under these credit facilities at October 28, 2001. At October 27, 2002, $40 million was outstanding under Japanese credit facilities at an average annual interest rate of 0.30 percent.

Novell

2002 Annual Report

I. Line of Credit

The Company currently has a $10 million unsecured revolving bank line of credit. The line of credit expires on March 3, 2003. The line can be used for either letter of revolving credit or working capital purposes and is subject to the terms of a loan agreement containing financial covenants and restrictions,

none of which are expected to significantly affect the Company's operations. At October 31, 2002, there were standby letters of credit of $7 million outstanding under this agreement.

In addition, at October 31, 2002, the Company had outstanding letters of credit totaling $3 million, primarily related to lease guarantees, which have largely been collateralized.

17. Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses at October 31 consisted of the following in millions of dollars:

	2004	*2003*
Equipment Operations		
Accounts payable:		
Trade payables	$1,246	$912
Dividends payable	69	53
Other	62	58
Accrued expenses:		
Employee benefits	719	349
Product warranties	458	389
Dealer sales program discounts	287	261
Dealer sales volume discounts	224	137
Other	619	613
Total	3,684	2,772
Financial Services		
Accounts payable:		
Deposits withheld from dealers and merchants	184	175
Other	239	234
Accrued expenses:		
Interest payable	85	79
Other	123	153
Total	631	641
Eliminations	341*	307*
Accounts payable and accrued expenses	$3,974	$3,106

[*] Trade receivable valuation accounts (primarily dealer sales program discounts) which are reclassified as accrued expenses by the Equipment Operations as a result.

Note 6—Exit or Disposal Activities

Management is continually re-evaluating the Company's operating facilities against its long-term strategic goals. Prior to January 1, 2003, upon commitment to a formal shutdown plan of an operating facility, provisions were made for all estimated qualified exit costs in accordance with EITF No. 94-3. Effective January 1, 2003, the Company recognizes liabilities associated with exit or disposal activities as incurred in accordance with SFAS No. 146. Qualified exit costs primarily include post-closure rent expenses, incremental post-closure costs and costs of employee terminations. Adjustments may be made to liabilities accrued for qualified exit costs if information becomes available upon which more accurate amounts can be reasonably estimated. Concurrently, property, plant, and equipment is tested for impairment in accordance with SFAS No. 144 and, if impairment exists, the carrying value of the related assets is reduced to estimated fair value. Additional impairment may be recorded for subsequent revisions in estimated fair value. No significant revisions occurred during 2004, 2003, or 2002.

The following table summarizes the activity and remaining liabilities associated with qualified exit costs:

Exit Plan	*Balance at December 31, 2003*	*Provisions in Cost of Goods Sold*	*Actual Expenditures Charged to Accrual*	*Adjustments to Prior Provisions in Other Expense - Net*	*Balance at December 31,2004*
Automotive finishes distribution facility shutdown in 2004:					
Severance and related costs ·····		$297	$(185)	$(112)	
Other qualified exit costs		903	(683)	96	$316
Consumer manufacturing facility shutdown in 2004:					
Other qualified exit costs		1,500	(1,810)	310	

Consumer manufacturing facility shutdown in 2001:					
Other qualified exit costs	$2,058		(186)	(25)	1,847
Other qualified exit costs for facilities shutdown prior to 2001	12,854		(650)	(232)	11,972
Totals	$14,912	$2,700	$(3,514)	$37	$14,135

Exit Plan	*Balance at December 31, 2002*	*Provisions in Cost of Goods Sold*	*Actual Expenditures Charged to Accrual*	*Adjustments to Prior Provisions in Other Expense - Net*	*Balance at December 31,2003*
Consumer manufacturing facility shutdown in 2001:					
Severance and related costs	$133		$(133)		
Other qualified exit costs	2,790		(641)	$(91)	$2,058
Paint Stores manufacturing facility shutdown in 2001:					
Other qualified exit costs	333		(105)	(228)	
Other qualified exit costs for facilities shutdown prior to 2001	13,221		(700)	333	12,854
Totals	16,477		$(1,579)	$14	$14,912

Exit Plan	*Balance at December 31, 2001*	*Provisions in Cost of Goods Sold*	*Actual Expenditures Charged to Accrual*	*Adjustments to Prior Provisions in Other Expense - Net*	*Balance at December 31,2002*
Consumer manufacturing facility shutdown in 2001:					
Severance and related costs	$1,454		$(1,321)		$133
Other qualified exit costs ·	1,946		(256)	$1,100	2,790
Paint Stores manufacturing facility shutdown in 2001:					

Severance and related costs	710	(667)	(43)	
Other qualified exit costs ·	290		43	333
Other qualified exit costs for facilities shutdown prior to 2001	15,479	(1,420)	(838)	13,221
Totals	$19,879	$(3,664)	$262	$16,477

During 2004, a formal plan was approved to close a leased distribution facility in the Automotive Finishes Segment. During 2003, a formal plan was approved to close a manufacturing facility in the Consumer Segment and the useful lives of the assets were reduced in accordance with SFAS No. 144. Both facilities were closed during 2004. In accordance with SFAS No. 146, noncancelable rent, post-closure severance and other qualified exit costs were accrued at the time of closing. No formal shutdown plans were approved during 2002.

Less than 7 percent of the ending accrual for qualified exit costs at December 31, 2004 related to facilities shutdown prior to 2002 that are expected to be incurred by the end of 2005. The remaining portion of the ending accrual primarily represented post-closure contractual and demolition expenses related to certain owned facilities which are closed and being held for disposal or involved in ongoing environmental-related remediation activities. The Company cannot reasonably estimate when such matters will be concluded to permit disposition.

Review Question Answers

Chapter 1 Review Questions

1. Delhi Co. is preparing its financial statements for the year ended December 31, 2002. Accounts payable amounted to $360,000 before any necessary year-end adjustment related to the following: 1) At December 31, 2002, Delhi has a $50,000 debit balance in its accounts payable to Madras, a supplier, resulting from a $50,000advance payment for goods to be manufactured to Delhi's specifications. 2) Checks in the amount of $100,000 were written to vendors and recorded on December 29, 2002. The checks were mailed on January 5, 2003. What amount should Delhi report as accounts payable in its December 31, 2002 balance sheet?

A. **Correct.** The ending accounts payable balance should include amounts owed as of 12/31/02, on trade payables. Although Delhi wrote checks for $100,000 to various vendors, that amount should still be included in the accounts payable balance because the company had not surrendered control of the checks at year-end. The advance to the supplier was erroneously recorded as a reduction of (debit to) accounts payable. This amount should be recorded as a repaid asset, and accounts payable should be credited (increased) by $50,000. Thus, accounts payable should be reported as $510,000 ($360,000 + $50,000 + $100,000).
B. Incorrect. $410,000 does not include the $100,000 in checks not yet mailed at year-end.
C. Incorrect. $310,000 does not include the $100,000 in checks, and it reflects the subtraction, not the addition, of the $50,000 advance.
D. Incorrect. $210,000 results from subtracting the advance payment and the checks.

2. According to GAAP, long-term obligations that are or will become callable by the creditor because of the debtor's violation of a provision of the debt agreement at the balance sheet date should be classified as

A. Incorrect. This kind of obligation should be classified as a current liability.
B. **Correct.** A current liability is defined as an obligation that will be either liquidated using a current asset or replaced by another current liability. Current liabilities include (1) obligations that by their terms are or will be due on demand within 1 year (or the operating cycle, if longer) and (2) obligations that are or will be callable by the creditor within 1 year because of a violation of a debt covenant. An exception exists, however, if the creditor has waived or subsequently lost the right to demand repayment for more than 1 year (or the operating cycle, if longer) from the balance sheet date.
C. Incorrect. The liability is not contingent.

D. Incorrect. The obligation may be classified as noncurrent if it is probable that the violation will be corrected within the grace period.

3. Buc Co. receives deposits from its customers to protect itself against nonpayments for future services. These deposits should be classified by Buc as

A. **Correct.** A customer deposit is a liability because it involves a probable future sacrifice of economic benefits arising from a current obligation of a particular entity to transfer assets or provide services to another entity in the future as a result of a past transaction.
B. Incorrect. A revenue is not recognized until it is earned.
C. Incorrect. GAAP ordinarily prohibits offsetting assets and liabilities. Most deferred credits are liabilities.
D. Incorrect. A contra account is a valuation account.

4. A company receives an advance payment for special order goods that are to be manufactured and delivered within 6 months. The advance payment should be reported in the company's balance sheet as a

A. Incorrect. An advance payment is a liability, recorded as an asset.
B. Incorrect. It is recorded on the asset side of the balance sheet. An advance payment is a liability.
C. **Correct.** A current liability is defined as an obligation that will be either liquidated using current assets or replaced by another current liability. The advance is for special order goods that are to be manufactured and delivered within 6 months. Hence, the obligation will be liquidated using current assets, and the advance payment should be reported as a current liability.
D. D is incorrect because the liability should be classified as current.

5. A retail store received cash and issued a gift certificate that is redeemable in merchandise. When the gift certificate was issued, a

A. Incorrect. The deferred revenue account should be decreased when the certificate expires or is redeemed, not when it is issued.
B. **Correct.** Revenue should be recognized when it is realized or realizable and earned. Revenue from a gift certificate is realized when the cash is received. However, it is not earned until the certificate expires or is redeemed. Consequently, when a gift certificate is issued, the company receiving the cash should record the issuance as a deferred revenue.

C. Incorrect. A revenue account is not affected when gift certificates are issued.
D. Incorrect. It is not earned until the certificate expires or is redeemed. Consequently, when a gift certificate is issued, the company receiving the cash should record the issuance as a deferred revenue. A revenue account is therefore not affected when it is issued.

6. Which of the following is the correct way to report assets and liabilities on the balance sheet under the fair value option?

A. **Correct.** One presentation approach is to show the balance sheet item as two separate line items for fair value and non-fair value carrying amounts. The other approach is to report them as one line item, but clearly note what dollar amount of that reported is measured at fair value.
B. Incorrect. ASC 825-10-25 (FAS-159) does not allow for the netting on the balance sheet. Rather, it states that an entity shall report its assets and liabilities that are subsequently measured at fair value in a manner that separates those reported fair values from the carrying amounts measured differently.
C. Incorrect. ASC 825-10-25 (FAS-159) does not allow for presenting a separate fair value mezzanine section. The assets and liabilities which are reported at fair value must still be reported in the appropriate balance sheet section.
D. Incorrect. The fair value option does not limit the presentation of an asset or liability to the long-term section of the balance sheet. Most entities will have both long- and short-term items that are measured at fair value.

7. Vadis Co. sells appliances that include a 3-year warranty. Service calls under the warranty are performed by an independent mechanic under a contract with Vadis. Based on experience, warranty costs are estimated at $30 for each machine sold. When should Vadis recognize these warranty costs?

A. Incorrect. The accrual method matches the costs and the related revenues.
B. Incorrect. When the warranty costs can be reasonably estimated, the accrual method should be used. Recognizing the costs when the service calls are performed is the cash basis.
C. Incorrect. Recognizing costs when paid is the cash basis.
D. **Correct.** Under the accrual method, a provision for warranty costs is made when the related revenue is recognized.

8. Which of the following statements characterizes convertible debt?

A. Incorrect. The holder of the debt has an option to receive (1) the face or redemption amount of the security or (2) common shares.
B. **Correct.** The debt and equity elements of convertible debt are inseparable. The entire proceeds should be accounted for as debt until conversion.
C. Incorrect. The entire proceeds should be accounted for as debt until conversion.
D. Incorrect. Conversion is favorable to the holder when the market value of the issuer's common stock is greater than the conversion price. (The conversion price exceeds market value upon initial issuance.)

9. On January 3, Year 1, North Company issued long-term bonds due January 3, Year 6. The bond covenant includes a call provision that is effective if the firm's current ratio falls below 2:1. On June 30, Year 1, the fiscal year-end for the company, its current ratio was 1.5:1. The bonds should be reported on the financial statements as a

A. Incorrect. The violation of the debt agreement would allow the creditor to accelerate the maturity date.
B. Incorrect. The debt should be classified as current unless it is probable that the violation will be cured within any grace period.
C. **Correct.** GAAP states that long-term obligations that are callable by the creditor because of the debtor's violation of the debt agreement at the balance sheet date shall be classified as current liabilities.
D. Incorrect. A creditor's waiver of the right to demand repayment of the debt would allow North to classify the bonds as long-term.

Chapter 2 Review Questions

1. A bond issued on June 1, 2X13 has interest payment dates of April 1 and October 1. Bond interest expense for the year ended December 31, 2X13 is for a period of

A. Incorrect. 3 months is the period for which interest is accrued at year-end.
B. Incorrect. 4 months is the period for which interest expense is recorded on October 1.
C. Incorrect. 6 months is the period between payment dates.

D. **Correct.** The price of a bond issued between payment dates includes the amount of accrued interest. Thus, this bond will include 2 months of accrued interest, which will be recorded as either a payable or a decrease in interest expense. As a result, interest expense for the year will be reported only for the period the bond is outstanding or 7 months (June-December).

2. On March 1, 2X13, Clark Co. issued bonds at a discount. Clark incorrectly used the straight-line method instead of the effective interest method to amortize the discount. How were the following amounts, as of December 31, 2X13, affected by the error?

A. Incorrect. The error understates retained earnings.
B. Incorrect. The error overstates the carrying amount.
C. **Correct.** The straight-line method records the same amount of expense (cash interest paid + proportionate share of discount amortization) for each period. The effective-interest method applies a constant rate to an increasing bond carrying amount (face value - discount + accumulated discount amortization), resulting in an increasing amortization of discount and increasing interest expense. Accordingly, in the first 10 months of the life of the bond, straight-line amortization of discount and interest expense is greater than under the effective-interest method. The effects are an understatement of unamortized discount, an overstatement of the carrying amount of the bonds, an understatement of net income, and an understatement of retained earnings.
D. Incorrect. The error overstates the carrying amount and understates retained earnings.

3. On March 31, 2X13, Ashley, Inc.'s bondholders exchanged their convertible bonds for common stock. The carrying amount of these bonds on Ashley's books was less than the market value but greater than the par value of the common stock issued. If Ashley used the *book-value method* of accounting for the conversion, which of the following statements correctly states an effect of this conversion?

A. **Correct.** Under the *book-value method* for recognizing the conversion of outstanding bonds payable to common stock, the stock issued is recorded at the carrying amount of the bonds with no recognition of gain or loss. Because the carrying amount of the bonds is greater than the par value of the common stock, the conversion will record common stock at par value and additional paid-in capital for the remainder of the carrying amount of the bonds. Ashley will decrease its liabilities (debit bonds payable) and increase its equity (credit common stock and additional paid-in capital).
B. Incorrect. Additional paid-in capital will increase.
C. Incorrect. Retained earnings is not directly affected.
D. Incorrect. No loss is associated with the conversion.

4. On March 1, 2X08, Somar Co. issued 20-year bonds at a discount. By September 1, 2X13, the bonds were quoted at 106 when Somar exercised its right to retire the bonds at 105. How should Somar report the bond retirement on its 2X13 income statement?

A. Incorrect. The amount paid exceeded the carrying amount. Thus, an ordinary loss is recognized.
B. **Correct.** All extinguishment of debt before scheduled maturities are fundamentally alike and should be accounted for similarly. Gains or losses from early extinguishment should be recognized in income of the period of extinguishment. Because the bonds were issued at a discount and were retired early for more than the carrying amount, a loss was incurred. Under GAAP, an event or transaction is perceived to be ordinary and usual absent clear evidence to the contrary. No such evidence is presented, and Somar should recognize an ordinary loss.
C. Incorrect. The amount paid exceeded the carrying amount. Thus, an ordinary loss is recognized.
D. Incorrect. The loss is presumptively ordinary absent contrary evidence.

5. The discount resulting from the determination of a note payable's present value should be reported on the balance sheet as a(n)

A. Incorrect. A premium would be reported as a direct addition to the face amount of the note.
B. Incorrect. The discount should not be classified as a deferred charge; instead it should be reported as a direct deduction from or addition to the face value of the note.
C. Incorrect. The discount should not be classified as a deferred credit on the balance sheet.
D. **Correct.** GAAP states that discount or premium is not an asset or liability separable from the related note. A discount or premium should therefore be reported in the balance sheet as a direct deduction from or addition to the face amount of the note.