

CHAPTER 10

Reporting and Analyzing Liabilities ANSWERS TO QUESTIONS

1. While this is generally true, more precisely a current liability is a debt that can reasonably be expected to be paid: (a) from existing current assets or through the creation of other current liabilities and (2) within one year or the operating cycle, whichever is longer.
2. In the balance sheet, Notes Payable of \$20,000 and Interest Payable of \$450 ($\$20,000 \times 9\% \times 3/12$) should be reported as current liabilities. In the income statement, Interest Expense of \$450 should be reported under other expenses and losses.
3. (a) Disagree. The company only serves as a collection agent for the taxing authority. It does not report sales taxes as an expense; it merely forwards the amount paid by the customer to the government.

(b) The entry to record the proceeds is:

| | | |
|---------------------------|-------|-------|
| Cash | 8,550 | |
| Sales Revenue | | 8,000 |
| Sales Taxes Payable | | 550 |
4. (a) The entry when the tickets are sold is:

| | | |
|-------------------------------|---------|---------|
| Cash | 900,000 | |
| Unearned Ticket Revenue | | 900,000 |

(b) The entry after each game is:

| | | |
|-------------------------------|---------|---------|
| Unearned Ticket Revenue | 180,000 | |
| Ticket Revenue | | 180,000 |
5. Three taxes commonly withheld by employers from employees' gross pay are (1) federal income taxes, (2) state income taxes, and (3) social security (FICA) taxes.
6. (a) Three taxes commonly paid by employers on employees' salaries and wages are (1) social security (FICA) taxes, (2) state unemployment taxes, and (3) federal unemployment taxes.

(b) Taxes withheld from employees' gross pay and not yet remitted to the appropriate government agency are reported in the balance sheet as current liabilities.
7. The liabilities that Tootsie Roll identified as current are: Accounts payable, Dividends payable, and Accrued liabilities.
8. (a) Long-term liabilities are obligations that are expected to be paid after one year. Examples include bonds and long-term notes.

(b) Bonds are a form of interest-bearing notes payable used by corporations, universities, and governmental agencies.

9. (a) Secured bonds have specific assets of the issuer pledged as collateral. In contrast, unsecured bonds are issued against the general credit of the borrower.
- (b) Convertible bonds permit bondholders to convert them into common stock at their option. In contrast, callable bonds are subject to call and redemption at a stated dollar amount prior to maturity at the option of the issuer.

Questions Chapter 10 (Continued)

10. (a) Face value is the amount of principal due at the maturity date.
- (b) The contractual interest rate is the rate used to determine the amount of cash interest the borrower pays and the investor receives. This rate is also called the stated interest rate because it is the rate stated on the bonds.
- (c) A bond certificate is a legal document that indicates the name of the issuer, the face value of the bonds, and such other information as the contractual interest rate and maturity date of the bonds.
11. (a) A convertible bond permits bondholders to convert it into common stock at the option of the bondholders.
- (b) For bondholders, the conversion option gives an opportunity to benefit if the market price of the common stock increases substantially. For the issuer, convertible bonds usually have: (1) a lower rate of interest than other debt securities, (2) a higher selling price.
12. The two major obligations incurred by a company when bonds are issued are the interest payments due on a periodic basis and the principal which must be paid at maturity.
13. Less than. Investors were required to pay more than the face value; therefore, the market interest rate is less than the contractual rate.
14. No, Jack is not right. The market price on any bond is a function of three factors: (1) the dollar amounts to be received by the investor (interest and principal), (2) the length of time until the amounts are received (interest payment dates and maturity date), and (3) the market interest rate.
15. \$48,000. $\$800,000 \times 6\% \times 1 \text{ year} = \$48,000$.
16. \$664,000. The balance of the Bonds Payable account minus the balance of the Discount on Bonds Payable account (or plus the balance of the Premium on Bonds Payable account) equals the carrying value of the bonds.
17. Debits: Bonds Payable (for the face value) and Premium on Bonds Payable (for the unamortized balance).
Credits: Cash (for 97% of the face value) and Gain on Bond Redemption (to balance entry).
18. Two issues need to be considered. First, by financing a major purchase such as this with short-term financing the company will reduce its liquidity. In the case of Mullins Inc., its current ratio will decrease from 2.2:1 to a less acceptable level of 1.5:1. However, of equal concern is that by financing a long-term project with short-term financing the company is exposing itself to interest rate risk. The company has the choice of locking in a long-term rate of 8%, or continually refinancing at whatever the short-term rate is when its short-term debt matures. If short-term rates increase substantially the increase in interest expense could significantly reduce the company's profitability.