

Chapter 10 - REPORTING AND ANALYZING LIABILITIES

LO 1: Explain how to account for current liabilities.

- **Current Liability:** “a debt that a company expects to pay
 1. from existing current assets or through the creation of other current liabilities, and
 2. ***within one year or the operating cycle, whichever is longer.***”
- Include ***notes payable, accounts payable, unearned revenues, and accrued liabilities*** such as ***taxes, salaries and wages, and interest***. ***Current maturities of long-term debt*** are also a current liability.

TYPES OF CURRENT LIABILITIES

1. **Notes Payable:** a written promissory note that usually requires the borrower to pay interest.
 - Frequently issued to meet short-term financing needs and for varying time periods.
 - Those due for payment within one year of the balance sheet date are usually classified as current liabilities.

Summary of Notes Payable Journal Entries

		DEBIT	CREDIT
1. To record issuance of a note.	Cash	xxx	
	Notes Payable		xxx
2. To accrue interest for a month or certain time period.	Interest Expense	xxx	
	Interest Payable		xxx
3. To record payment of the note and accrued interest.	Notes Payable	xxx	
	Interest Payable	xxx	
	Cash		xxx

Ex: On April 1, Holton Company borrows \$100,000 from West Bank by signing a 6-month, 6%, interest-bearing note.

Prepare the necessary entries below associated with the note payable on the books of Holton Company.

- Prepare the entry on April 1 when the note was issued.
- Prepare any adjusting entries necessary on June 30 in order to prepare the semiannual financial statements. Assume no other interest accrual entries have been made.

	Date	Debit	Credit
Cash	Apr. 1	100,000	
Notes Payable			100,000
Interest Expense	Jun. 30	1,500	
Interest Payable (\$100,000 x 6% x (3/12))			1,500

$$\text{Face Value of Note} \times \text{Annual Interest Rate} \times \text{Time in Terms of One Year} = \text{Interest}$$

2. Sales Taxes Payable: sales taxes that have to be paid to the government.

- Sales taxes are expressed as a stated percentage of the sales price.
- The selling company collects the tax from the customer and then remits the collections to the state's department of revenue (usually monthly.)

Summary of Sales Tax Payable Journal Entries

		DEBIT	CREDIT
	Cash	xxx	
1. To record daily sales and sales taxes.	Sales Revenue		xxx
	Sales Taxes Payable		xxx

Ex 1: On May 28 cash register readings for Holton Company shows sales of \$20,000 and sales taxes of \$2,000 (sales tax rate of 2% x \$20,000). The journal entry is

	Date	Debit	Credit
Cash	May 28	22,000	
Sales Revenue			20,000
Sales Taxes Payable (\$20,000 x 2%)			2,000

Ex 2: On May 28 Holton Company rings up total receipts of \$22,000. The amount received includes a tax on 10% of sales. The journal entry is

	Date	Debit	Credit
Cash	May 28	22,000	
Sales Revenue (\$22,000 ÷ 1.10)			20,000
Sales Taxes Payable (\$22,000 - \$20,000)			2,000

3. Unearned Revenue: cash that is received BEFORE goods are delivered or services are performed.

- Current liability on the balance sheet.

Summary of Unearned Revenue Journal Entries

		DEBIT	CREDIT
1. To record receipt of cash before goods are delivered or work is performed.	Cash	xxx	
	Unearned Revenue		xxx
2. To record recognition of revenue earned from delivering goods or providing a service.	Unearned Revenue	xxx	
	Revenue		xxx

Ex: Intelligent University sells 20,000 season football tickets at \$30 each for its 8-game home schedule on August 1. The entry for the sales of season tickets is:

	Date	Debit	Credit
Cash	Aug. 1	600,000	
Unearned Ticket Revenue (20,000 x \$30)			600,000

On Aug. 28, the first home game for Intelligent University was completed. Intelligent University records the earning of revenue with the following journal entry.

	Date	Debit	Credit
Unearned Ticket Revenue	Aug. 28	75,000	
Ticket Revenue (\$60,000 ÷ 8 games)			75,000

4. Payroll and Payroll Taxes Payable:

Summary of Payroll Taxes Journal Entries			
		DEBIT	CREDIT
1. To record payroll and withholding taxes for the week or other time period.	Salaries and Wages Expense	xxx	
	FICA Taxes Payable		xxx
	Federal Income Taxes Payable		xxx
	State Income Taxes Payable		xxx
	Salaries and Wages Payable		xxx
2. To record payment of the payroll.	Salaries and Wages Payable	xxx	
	Cash		xxx
3. To record employer's payroll taxes.	Payroll Tax Expense	xxx	
	FICA Taxes Payable		xxx
	Federal Unemployment Taxes Payable		xxx
	State Unemployment Taxes Payable		xxx

- Payroll pertains to both:
 1. **Salaries** - managerial, administrative, and sales personnel (**monthly or yearly rate**).
 2. **Wages** - store clerks, factory employees, and manual laborers (**rate per hour**).
- Gross Pay – Payroll Deductions = **Net Pay (What the employee takes home)**
- Payroll deductions include:
 1. Insurance, pensions, and/or union dues
 2. FICA Taxes (Social Security and Medicare)
 3. Federal Income Tax
 4. State and City Income Taxes
 5. Charity

- In addition to withholding taxes from their employees to remit to the government, employers have to pay payroll taxes.

- Payroll taxes include FICA Tax, Federal Unemployment Tax, and State Unemployment Tax.

Ex: During the month of March, Preston Company's employees earned wages of \$90,000. Withholdings related to these wages were \$6,885 for Social Security (FICA), \$14,200 for federal income tax, and \$6,200 for state income tax. The company incurred no cost related to these earnings for federal unemployment tax, but incurred \$1,300 for state unemployment tax.

- (a) Prepare the necessary March 31 journal entry to record wages expense and wages payable. Assume that wages earned during March will be paid during April.

	Date	Debit	Credit
Salaries and Wages Expense	Mar. 31	90,000	
FICA Taxes Payable			6,885
Federal Income Taxes Payable			14,200
State Income Taxes Payable			6,200
Salaries and Wages Payable			62,715

- (b) Prepare the entry to record the company's payroll tax expense.

	Date	Debit	Credit
Payroll Expense	Mar. 31	8,185	
FICA Taxes Payable			6,885
State Unemployment Taxes Payable			1,300

LO 2: Describe the major characteristics of bonds.

- **Long-term Liabilities:** “Obligations that a company expects to pay MORE THAN ONE YEAR in the future.”

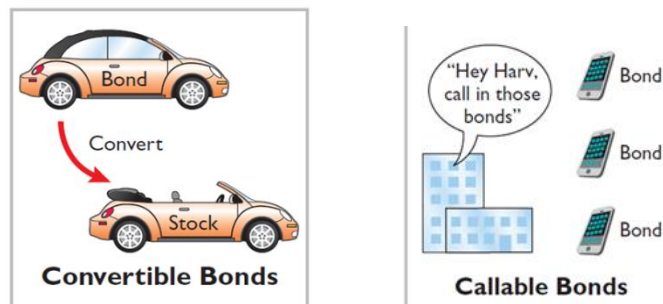
BONDS

- “a form of interest-bearing notes payable issued by corporations, universities, and governmental agencies.”
- Sold in small denominations (usually \$1,000 or multiples of \$1,000).
- When a corporation issues bonds, it is borrowing money. The person who buys the bonds (the bondholder) is investing in bonds.

***** BOND ISSUANCE RESULTS IN CASH GOING UP BECAUSE THE COMPANY ISSUING THE BOND IS BORROWING MONEY.**

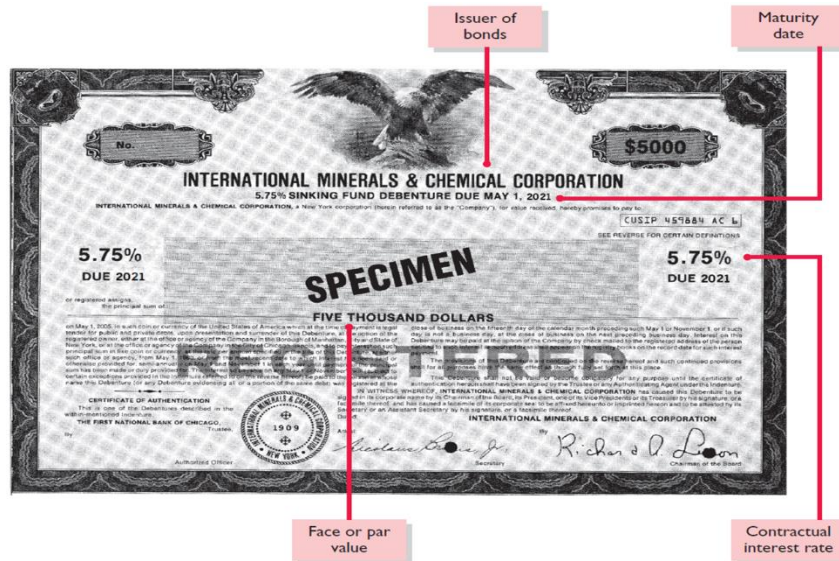
TYPES OF BONDS

1. **Secured bonds:** have specific assets of the issuer pledged as collateral for the bonds.
2. **Unsecured bonds:** are issued against the general credit of the borrower.
3. **Convertible bonds:** can be converted into common stock at the bondholder’s option.
4. **Callable bonds:** can be redeemed (bought back), by the issuing company, at a stated dollar amount prior to maturity.



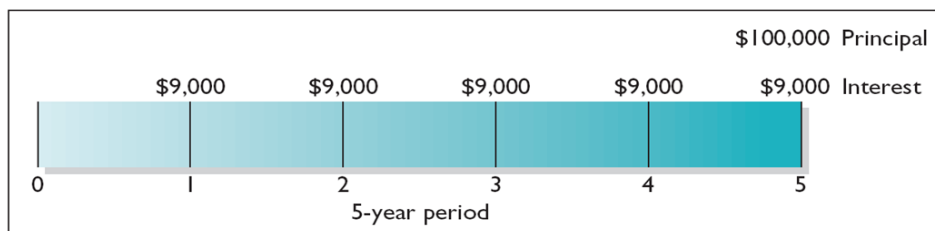
ISSUING BONDS

- **Bond Certificate:** issued to the investor and provides the name of the company issuing bonds, face value, maturity date, and contractual (stated) interest rate.
- **Face Value:** principal due at the maturity.
- **Maturity Date:** date final payment is due to the investor from the issuing company.
- **Contractual Interest Rate:** rate to determine cash interest paid. It is stated as an annual rate.



- The current market price (present value) of a bond is a function of three factors:
 - The dollar amounts to be received.
 - The length of time until the amounts are received.
 - The **market rate of interest** (the rate investors demand for loaning funds.)
- Time value of money:** a dollar received today is worth more than a dollar promised at some time in the future.
- The current market price of a bond is equal to the **present value of all future cash payments promised by the bond**.

Ex: Assume that Meteor Company on January 1, 20X1, issues \$100,000 of 9% bonds, due in five years, with interest payable annually at year-end.



- Meteor company has to pay \$9,000 ($\$100,000 \times 9\%$) at the END of each year for the next 5 years in addition to the \$100,000 that it has to pay back at the end of 5 years.
- The market price of the bonds would factor in the 5 interest payments of \$9,000 and the payment of the face amount in 5 years.

Present value of \$100,000 received in 5 years	\$ 64,993
Present value of \$9,000 received annually for 5 years	35,007
Market price of bonds	<u>\$100,000</u>

LO 3: Explain how to account for bond transactions.

- A corporation records bond transactions when it issues (sells) or redeems (buys back) bonds and when bondholders convert bonds into common stock.
- Bonds may be issued at...
 1. **Face Value**
 2. **Below Face Value (Discount)**
 3. **Above Face Value (Premium)**
- **Key Relationship between Contract Rate (SET BY BOND), Market Rate (SET BY MARKET), and Bond Price. The journal entries for the issuance of the bonds are recorded below.**
- **Contractual interest rate** = rate applied to the face value (par) to arrive at the interest paid for a year.
- **Market interest rate** = rate investors demand for loaning funds to the corporation.

1. Market Rate = Contract Rate → Bonds issued at Face Value.

	Date	Debit	Credit
Cash		XXX	
Bonds Payable			XXX

2. Market Rate > (GREATER THAN) Contract Rate → Discount (Bonds less than Face Value)

	Date	Debit	Credit
Cash		XXX	
Discount on Bonds Payable		XXX	
Bonds Payable			XXX

3. Market Rate (LESS THAN) < Contract Rate → Premium (Bonds more than Face Value)

	Date	Debit	Credit
Cash		XXX	
Bonds Payable			XXX
Premium on Bonds Payable			XXX

- Bond prices are quoted as a percentage of face value.
 1. Bonds quoted **BELOW 100 are offered at a DISCOUNT**. If a \$1,000 bond is offered at 96 (96% of face value), the selling price of the bond is **\$960** ($\$1,000 \times .96$)
 2. Bonds quoted **ABOVE 100 are offered at a PREMIUM**. If a \$1,000 bond is offered at 102 (102% of face value), the selling price of the bond is **\$1,020** ($\$1,000 \times 1.02$)
 3. Bonds quoted **AT 100 are offered at FACE VALUE**. If a \$1,000 bond is offered at 100 (100% of face value), the selling price of the bond is **\$1,000** ($\$1,000 \times 1.00$)

ISSUING BONDS AT FACE

- Occurs when **MARKET RATE = CONTRACT RATE** or bonds are quoted **at 100**.

Ex: (A) Denver Corporation issues 100, five-year, 10%, \$1,000 bonds dated January 1, 20X1, at 100 (100% of face value). The entry to record the sale is:

	Date	Debit	Credit
Cash	Jan. 1	100,000	
Bonds Payable ($100 \times \$1,000$)	20X1		100,000

(B) Prepare the entry Denver would make to accrue interest on December 31.

	Date	Debit	Credit
Interest Expense	Dec. 31	10,000	
Interest Payable ($\$100,000 \times 10\% \times 12/12$)	20X1		10,000

(C) Prepare the entry Denver would make to pay the interest on Jan. 1, 20X2.

	Date	Debit	Credit
Interest Expense	Jan. 1	10,000	
Interest Payable ($\$100,000 \times 10\% \times 12/12$)	20X2		10,000

ISSUING BONDS AT A DISCOUNT

- Occurs when **MARKET RATE > CONTRACT RATE** or bonds are quoted **BELOW 100**.
- Ex:** Denver Corporation issues 100, five-year, 10%, \$1,000 bonds dated January 1, 20X1, at 98(98% of face value) with interest payable January 1. The entry to record the sale is:

	Date	Debit	Credit
Cash ($100 \times \$1,000 \times 0.98$)	Jan. 1	98,000	
Discount on Bonds Payable	20X1	2,000	
Bonds Payable ($100 \times \$1,000$)			100,000

- Sale of bonds below face value** causes the total cost of borrowing to be more than the bond interest paid.
- The issuing corporation not only must **pay the contractual interest rate** over the term of the bonds but also must **pay the face value** (rather than the issuance price) at maturity.

Bonds Issued at a Discount	
Annual interest payments ($\$100,000 \times 10\% = \$10,000$; $\$10,000 \times 5$)	\$50,000
Add: Bond discount ($\$100,000 - \$98,000$)	2,000
Total cost of borrowing	\$52,000

Bonds Issued at a Discount	
Principal at maturity	\$100,000
Annual interest payments ($\$10,000 \times 5$)	50,000
Cash to be paid to bondholders	150,000
Less: Cash received from bondholders	98,000
Total cost of borrowing	\$ 52,000

- **Discount on Bonds Payable** is a contra account that is deducted from bonds payable on the balance sheet.

Long-term liabilities			
Bonds payable		\$100,000	
Less: Discount on bonds payable		<u>2,000</u>	\$98,000

ISSUING BONDS AT A PREMIUM

- Occurs when **MARKET RATE < CONTRACT RATE** or bonds are quoted **ABOVE 100**.
- **Ex:** Denver Corporation issues 100, five-year, 10%, \$1,000 bonds dated January 1, 20X1, at 102(102% of face value) with interest payable January 1. The entry to record the sale is:

	Date	Debit	Credit
Cash ($100 \times \$1,000 \times 1.02$)	Jan. 1	102,000	
Bonds Payable ($100 \times \$1,000$)	20X1		100,000
Premium on Bonds Payable			2,000

- **Sale of bonds above face value** causes the total cost of borrowing to be **less** than the bond interest paid.
- The borrower is not required to pay the bond premium at the maturity date of the bonds. Thus, the bond premium is considered to be a reduction in the cost of borrowing.

Bonds Issued at a Premium	
Annual interest payments ($\$100,000 \times 10\% = \$10,000$; $\$10,000 \times 5$)	\$ 50,000
Less: Bond premium ($\$102,000 - \$100,000$)	<u>2,000</u>
Total cost of borrowing	<u>\$48,000</u>

Bonds Issued at a Premium	
Principal at maturity	\$100,000
Annual interest payments ($\$10,000 \times 5$)	<u>50,000</u>
Cash to be paid to bondholders	150,000
Less: Cash received from bondholders	<u>102,000</u>
Total cost of borrowing	<u>\$ 48,000</u>

- **Premium on Bonds Payable** is added to bonds payable on the balance sheet.

Long-term liabilities		
Bonds payable	\$100,000	
Add: Premium on bonds payable	<u>2,000</u>	\$102,000

LO 5: Apply the straight-line method of amortizing bond discount and bond premium.

AMORTIZATION OF BOND DISCOUNT

- Allocated to expense in each period.
- **INCREASES** the amount of **interest expense** reported each period.
- Amount of interest expense reported each period will exceed the contractual amount paid.
- As the discount is amortized, its balance declines.
- **The carrying value of the bonds will increase, until at maturity the carrying value of the bonds equals their face amount.**

Interest Expense = Interest Paid (Par Value X Contract Interest Rate) + Amortized Discount on Bonds Payable

- Bond discount must be reduced and ADDED to interest expense to reflect the passage of time. This process INCREASES the contract rate of interest on a bond to the market rate of interest that existed on the date the bonds was issued.

$$\text{BOND DISCOUNT} \div \text{NUMBER OF INTEREST PERIODS} = \text{BOND DISCOUNT AMORTIZATION}$$

- **Previous Example:** (A) Denver Corporation issues 100, five-year, 10%, \$1,000 bonds dated January 1, 20X1, at 98(98% of face value) with interest payable January 1. The entry to record the sale is:

	Date	Debit	Credit
Cash ($100 \times \$1,000 \times 0.98$)	Jan. 1	98,000	
Discount on Bonds Payable	20X1	2,000	
Bonds Payable ($100 \times \$1,000$)			100,000

(B) Prepare the entry to accrue interest and amortize the bond discount at Dec. 31, 20X1.

Step 1: Bond Discount Amortization = Bond Discount \div Number of Interest Periods

Bond Discount Amortization = $\$2,000 \div 5 \text{ years} = \underline{\$400 \text{ per year}}$

Step 2: Interest Payable = Face Value \times Contractual Rate

Interest Payable = $\$100,000 \times 10\% = \underline{\$10,000}$

Step 3:

Interest Expense = Interest to be Paid + Amortized Discount on Bonds Payable

Interest Expense = $\$10,000 + \$400 = \underline{\$10,400}$

	Date	Debit	Credit
Interest Expense	Dec. 31	10,400	
Discount on Bonds Payable	20X1		400
Interest Payable			10,000

Bond Discount Amortization Schedule Straight-Line Method—Annual Interest Payments \$100,000 of 10%, 5-Year Bonds					
Interest Periods	(A) Interest to Be Paid (10% × \$100,000)	(B) Interest Expense to Be Recorded (A) + (C)	(C) Discount Amortization (\$2,000 ÷ 5)	(D) Unamortized Discount (D) – (C)	(E) Bond Carrying Value (\$100,000 – D)
Issue date				\$2,000	\$ 98,000
1	\$10,000	\$10,400	\$ 400	1,600	98,400
2	10,000	10,400	400	1,200	98,800
3	10,000	10,400	400	800	99,200
4	10,000	10,400	400	400	99,600
5	10,000	10,400	400	0	100,000
	<u>\$50,000</u>	<u>\$52,000</u>	<u>\$2,000</u>		

**Each year the same journal entry would be made. The discount amortization, interest expense, and interest to be paid remain the same each year.*

AMORTIZATION OF BOND PREMIUM

- Allocated to expense in each period.
- DECREASES** the amount of **interest expense** reported each period.
- Amount of interest expense reported each period will be less than the contractual amount paid.
- As the premium is amortized, its balance declines.
- The carrying value of the bonds will decrease, until at maturity the carrying value of the bonds equals their face amount.**

Interest Expense = Interest Paid (Par Value X Contract Interest Rate) - Amortized Premium on Bonds Payable

- The amortization of a bond premium **DECREASES** the contract rate of interest on a bond to the market rate of interest that existed on the date the bonds were issued

$$\text{BOND PREMIUM} \div \text{NUMBER OF INTEREST PERIODS} = \text{BOND PREMIUM AMORTIZATION}$$

- Previous Example:** (A) Denver Corporation issues 100, five-year, 10%, \$1,000 bonds dated January 1, 20X1, at 102(102% of face value) with interest payable January 1. The entry to record the sale is:

	Date	Debit	Credit
Cash (100 × \$1,000 × 1.02)	Jan. 1	102,000	
Bonds Payable (100 × \$1,000)	20X1		100,000
Premium on Bonds Payable			2,000

(B) Prepare the entry to accrue interest and amortize the bond premium at Dec. 31, 20X1.

Step 1: Bond Premium Amortization = Bond Premium ÷ Number of Interest Periods

Bond Premium Amortization = \$2,000 ÷ 5 years = **\$400 per year**

Step 2: Interest Payable = Face Value × Contractual Rate

Interest Payable = \$100,000 × 10% = **\$10,000**

Step 3:

Interest Expense = Interest to be Paid - Amortized Premium on Bonds Payable

Interest Expense = \$10,000 - \$400 = **\$9,600**

	Date	Debit	Credit
Interest Expense	Dec. 31	9,600	
Premium on Bonds Payable	20X1	400	
Interest Payable			10,000

***Each year the same journal entry would be made. The premium amortization, interest expense, and interest to be paid remain the same each year.**

Bond Premium Amortization Schedule Straight-Line Method—Annual Interest Payments \$100,000 of 10%, 5-Year Bonds					
Interest Periods	(A) Interest to Be Paid (10% × \$100,000)	(B) Interest Expense to Be Recorded (A) – (C)	(C) Premium Amortization (\$2,000 ÷ 5)	(D) Unamortized Premium (D) – (C)	(E) Bond Carrying Value (\$100,000 + D)
Issue date				\$2,000	\$102,000
1	\$ 10,000	\$ 9,600	\$ 400	1,600	101,600
2	10,000	9,600	400	1,200	101,200
3	10,000	9,600	400	800	100,800
4	10,000	9,600	400	400	100,400
5	10,000	9,600	400	0	100,000
	<u>\$50,000</u>	<u>\$48,000</u>	<u>\$2,000</u>		

LO 3: Explain how to account for bond transactions conclusion. (Redeeming Bonds)

BOND REDEMPTION AT MATURITY

Bond Redemption = Pay back the face value of the bond owed.

- The book value of the bonds at maturity will equal their face value.
- Does NOT matter if there was a bond discount or premium.

	Date	Debit	Credit
Bonds Payable		XXX	
Cash			XXX

Ex: The journal entry to record the redemption of 100, five-year, 10%, \$1,000 bonds at the end of the 5th year assuming the company records the redemption of bonds at maturity is

	Date	Debit	Credit
Bonds Payable	Dec. 31	100,000	
Cash	20X5		100,000

BOND REDEMPTION BEFORE MATURITY

- When a company retires bonds before maturity, it is necessary to:
 1. Eliminate the carrying value of the bonds at the redemption date.
 2. Record the cash paid.
 3. Recognize the gain or loss on redemption.

If bond's carrying value > the cash paid to retire bond = GAIN ON RETIREMENT OF BONDS FOR ISSUER.

If bond's carrying value < the cash paid to retire bond = LOSS ON RETIREMENT OF BONDS FOR ISSUER.

Carrying Value of Bond = Face Value of Bond – Unamortized Bond Discount

OR **Carrying Value of Bond** = Face Value of Bond + Unamortized Bond Premium

Summary of Bond Redemption Before Maturity Journal Entries			
		DEBIT	CREDIT
1. To record redemption of bonds issued at a discount for a loss.	Bonds Payable	xxx	
	Loss on Bond Redemption	xxx	
	Discount on Bonds Payable		xxx
	Cash		xxx
2. To record redemption of bonds issued at a discount for a gain.	Bonds Payable	xxx	
	Discount on Bonds Payable		xxx
	Gain on Bond Redemption		xxx
	Cash		xxx
3. To record redemption of bonds issued at a premium for a loss.	Bonds Payable	xxx	
	Premium on Bonds Payable	xxx	
	Loss on Bond Redemption	xxx	
	Cash		xxx
4. To record redemption of bonds issued at a premium for a gain.	Bonds Payable	xxx	
	Premium on Bonds Payable	xxx	
	Gain on Bond Redemption		xxx
	Cash		xxx

Ex: Company B issued \$200,000 callable bonds. The bonds were for 10 years, but Company B decided to retire the bonds (pay them back) at the end of the 8th year. The \$200,000 bonds are retired at 104 after paying the annual interest. Assume the carrying value of the bonds at the redemption date is \$207,000 (principal and \$7,000 premium). Company B would record the bond redemption at the end of the 8th year as:

	Date	Debit	Credit
Bonds Payable	Dec. 31	200,000	
Premium on Bonds Payable	20X8	7,000	
Loss on Bonds Payable		1,000	
Cash (\$200,000 x 1.04)			208,000

Carrying Value of Bond = \$207,000

Cash Paid to Retire Bond = \$208,000

Loss = \$208,000 - \$207,000 = **\$1,000** because cash paid to retire bond was GREATER than the carrying value of the bond.

LO 4: Discuss how liabilities are reported and analyzed.

MARAIS COMPANY		
Balance Sheet (partial)		
Liabilities		
Current liabilities		
Notes payable	\$ 250,000	
Accounts payable	125,000	
Current maturities of long-term debt	300,000	
Accrued liabilities	75,000	
Total current liabilities		\$ 750,000
Long-term liabilities		
Bonds payable	1,000,000	
Less: Discount on bonds payable	80,000	920,000
Notes payable, secured by plant assets		540,000
Lease liability		500,000
Total long-term liabilities		1,960,000
Total liabilities		\$2,710,000

Current Liabilities: those DUE WITHIN ONE YEAR or company's operating cycle (whatever is LONGER) (Accounts payable, wages payable, short-term notes payable, interest payable, unearned revenue, sales taxes payable, etc.)

***Current maturities of long-term debt should be reported as a current liability.

Long-Term Liabilities: NOT EXPECTED TO BE PAID WITHIN THE LONGER OF ONE YEAR or the company's operating cycle. (Long-term notes payable, bonds payable, and lease liabilities.)

ANALYSIS

Liquidity Ratios: measure the short-term ability of a company to pay its maturing obligations and to meet unexpected needs for cash.

Ex:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

- Usually, a current ratio above 1 is a good sign for a company because they have a greater ability to pay current liabilities from current assets.
- A current ratio of 3.5 means a company has \$3.50 of current assets for every \$1 of current liabilities.

Solvency Ratios: measure the ability of a company to survive over a long period of time.

$$\text{Debt to Assets Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

- The higher the ratio, the more the company relies on debt to finance their assets.
- A debt to assets ratio of 80% indicates that a company finances \$1 of assets with \$0.80 of debt.

$$\text{Times Interest Earned} = \frac{\text{Net Income} + \text{Interest Expense} + \text{Income Tax Expense}}{\text{Interest Expense}}$$

- Provides an indication of a company's ability to meet interest payments as they come due.
- A company that has a number of times interest charges are earned of 30 times is better than a company that has 10 times. Creditors would be more likely to give a loan to the company with 30 times interest charges are earned because they have a better ability to pay their interest payments even if earnings decrease.

CONTINGENCIES

- "Events with uncertain outcomes that may represent potential liabilities."
- A common types of contingencies:
 1. Lawsuits.
 2. Product warranties.
 3. Environmental cleanup obligations.
- Accounting rules require that companies disclose contingencies in the notes.
- If a company can determine a **REASONABLE ESTIMATE** of the expected loss and if it is **PROBABLE** it will lose the lawsuit, then the company should accrue for the loss.