

CHAPTER 12

Non-current financial liabilities

LEARNING OBJECTIVES

- 12-1. Describe financial leverage and its impact on profitability.
- 12-2. Describe the categories and types of non-current liabilities.
- 12-3. Describe the initial and subsequent measurement of non-current financial liabilities and account for these obligations.
- 12-4. Apply accrual accounting to the derecognition of financial liabilities.
- 12-5. Apply accrual accounting to decommissioning and site restoration obligations
- 12-6. Describe how non-current liabilities are presented and disclosed.

OVERALL APPROACH

Exhibit 12-2 on page 569 summarizes the different topical coverage of the previous chapter and this one. Chapter 11 covered non-financial liabilities, as well as current financial liabilities (e.g., accounts payable). This chapter focuses on non-current financial liabilities such as long-term notes and bonds, although in many cases some portion of these liabilities will have a portion classified as current.

This chapter goes into considerable depth on the application of present value techniques required for the amortized cost method of accounting for financial instruments. In comparison to the holders of these instruments, the issuers are much more likely to have the instruments outstanding until maturity or at least a significant portion of that period, so the issue is more relevant here.

This chapter does not cover compound financial instruments with both debt and equity components. Instead, the topic is deferred to Chapter 14, after the coverage of equity in Chapter 13.

KEY POINTS

Financial leverage: The chapter opens with a discussion of financial leverage to ensure that students understand the financial economic reasons why a company might issue debt instead of equity, and why different companies would choose different levels of leverage. Without this understanding, many students are likely to think that less debt is always better because of a general aversion to debt (e.g., student debt).

Debt rating agencies: These agencies provide a vital service to assist investors in making informed decisions. The agencies are independent and impartial evaluators which help to reduce the costs of financing.

Nature of notes and bonds payable: This topic has been introduced previously in Chapter 11 as well as in Chapter 5 (in the form of notes receivable). While students are likely to be somewhat familiar with mortgages and other loans obtained from banks, they probably have had little real life experience with notes and bonds, so some additional discussion is warranted. Students should also understand the concept of a “covenant” as it pertains to notes and bonds payable. The discussion of spreads is important to help students understand why companies would borrow by way of notes and bonds instead of borrowing from a bank or other financial institution.

Types of bonds: There is a plethora of different types of bonds (secured, zero-coupon, callable, convertible, etc.). It will be helpful to allay students’ fear that they will be expected to memorize what all the different names mean. Rather the focus should be on the accounting for these bonds. In practice, accountants will have access to reference sources that define these terms.

Initial measurement: The first issue to clarify here is the treatment of issuance costs. For assets, the initial recognition is at fair value *plus* any transaction costs. In contrast, enterprises should record financial liabilities at fair value *less* transaction costs (except for financial instruments classified as held-for-trading). Two simple journal entries will make this point clear.

Dr. Inventories	102	Dr. Cash (fair value)	100
Cr. Cash (shipping cost)	2	Cr. Cash (issuance cost)	2
Cr. Cash (invoice cost)	100	Cr. Bond payable	98

(Note that up until 2010, IAS 39 had erroneously used the same wording for financial instrument purchases as well as issuances, which made no sense.)

The second issue in initial measurement arises from the issuance of debt for non-monetary consideration. Chapter 8 previously covered non-monetary exchanges, so the discussion in this chapter merely serves as a review.

The third issue relates to the yield and any differences from the coupon rate. Students need to be proficient in determining both (i) the yield given the proceeds, and (ii) the value of the bond given the yield. Partly, this will be a review of Chapter 7. This chapter uses the net method of recording discount and premium bonds, rather than using separate accounts for the face value and the discount or premium. This approach is simpler and makes it more apparent to students the carrying value of the bond at any point in time. The net method also connects directly to the bond amortization schedules that students will need to construct.

A final issue in initial measurement is the accounting for the “stub period” between the legal issuance date according to the bond indenture and the actual date when the bonds are sold.

Subsequent measurement: This chapter focuses on the effective interest method because IFRS requires it for financial instruments carried at amortized cost. The textbook has an extensive demonstration using the effective interest method in Exhibits 12-9 – 12-11. Students should also practice prorating interest and amortization when the interest payments do not coincide with year end. Pages 582-583 also briefly discuss and illustrate the straight-line method that is permitted under ASPE. For either method, it is important that students be able to construct the appropriate bond amortization schedules, and then pull out the relevant information for journal entries.

Students should be encouraged to, when using a spreadsheet for the amortization table, to complete the entire table to confirm that the bond fully amortizes to face value at the maturity date. This procedure provides a check for whether they have used the correct information and calculations.

Derecognition: Accounting for bonds at maturity is straight-forward. However, derecognition prior to maturity is complicated by the gain or loss that arises from early redemption. To compute the gain or loss, students will first need to be able to compute the carrying value of the bond by either (i) constructing the bond amortization schedule up to the date of the debt retirement, or (ii) computing the value of the bond using the remaining time to maturity and the original yield. The latter method will be faster when a significant amount of time has elapsed since the bond’s issuance. In any case, demonstrating this method, and how it matches up to the amortization schedule, helps to solidify students’ understanding of the amortized cost method.

Decommission and site restoration obligations: This topic is a review of material in Chapter 8, but it is useful to review with students ensuring they understand that this type of liability is a non-financial provision measured at the present value of the estimated future obligation

It is important to discuss the general prohibition against offsetting amounts in the financial statements, and the consequent denial of in-substance defeasance as a method to derecognize financial liabilities. This issue was first brought up in a case study in Chapter 1, but it bears reminding even if students had covered that case before.

Bonds denominated in foreign currency: Accounting for bonds issued in US dollars or other foreign currency is similar to accounting for any obligation denominated in a foreign currency. This topic was covered in Chapter 11 but it worthwhile to review it with students using bonds. It is important that students understand the difference between the “spot rate” and the “average rate” and which rate is used in initial measurement, subsequent measurement and derecognition.

USE OF END-OF-CHAPTER PROBLEMS AND CASES

In addition to lectures, discussion of some of the end-of-chapter problems and cases will help students apply the concepts. The following table identifies the suggested problems and cases that could be used in class, as well as other suggested problems for homework assignments. (Depending on the time allocation between lectures and examples, it may not be feasible to cover all of the suggested items.)

Table 12-1:

Summary of learning objectives, chapter content, and suggested problems and cases

L.O. number	Learning objective	Pages	Suggestions for in-class discussion	Suggestions for assignments
12-1.	Describe financial leverage and its impact on profitability.	566-569	P12-1	P12-3
12-2.	Describe the categories and types of non-current liabilities.	569-572	P12-4	P12-5
12-3.	Describe the initial and subsequent measurement of non-current financial liabilities and account for these obligations.	572-583	P12-22	P12-7 P12-13 P12-21
12-4.	Apply accrual accounting to the derecognition of financial liabilities.	584-590	P12-29	P12-30
12-5	Apply accrual accounting to decommission and site restoration obligation	590-596	P12-41	P12-42
12-6.	Describe how non-current liabilities are presented and disclosed.	596-597	P12-46	P12-47
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Jackson Capital Inc. involves a (simulated) private company that invests in the debt and equity of other companies. The company has financed these investments via \$12 million of equity and \$12 million of long-term debt. The equity includes \$7 million of redeemable preferred shares, while the debt includes \$6 million of bonds that are indexed to the TSX Composite index. Students play the role of Jackson Capital's auditor and discuss the accounting issues and cash flow issues relating to its debt and equity.

Total Protection Limited also involves a simulated company that provides third-party (non-manufacturer) warranties on newly-built homes. The company was created by five home-builders to provide warranties on homes built by themselves as well as by other

builders. This case integrates issues relating to financial liabilities and revenue recognition.