

FA Module 11: Long-term (non-current) liabilities (overview 4<sup>th</sup> edition)

(The attached PDF file has better formatting.)

(Readings from the fourth 4<sup>th</sup> edition of the Robinson text.)

Reading: chapter 10

- ! § 2 bonds payable, *excluding*
  - " Example 5 (Fair value disclosures of debt and financial instruments)
  - " Sub-section 2.4 (derecognition of debt) and Example 6 Debt Extinguishment Disclosure
  - " Example 7 (Illustration of debt covenant disclosures: TORM A/S)
  - " Sub-section 2.6 (presentation and disclosure of long-term debt) and Example 8 Illustration of Long-Term Debt Disclosures and Example 9 Financial Statement Disclosure of Bonds with Warrants
- ! § 5 evaluating solvency: leverage and coverage ratios

§§ 3 and 4 are not covered in this course.

Know the relations of interest expense, interest paid, changes in accrued interest, amortization of premium, and accrual of discount. The articulation is similar to that for all financial statement entries. Interest expense and interest income include amortization of premium and accrual of discount.

Evaluating present values at specified discount rates and amortizing bond discounts are common actuarial techniques. Know the computations in Example 1 Bonds Issued at Face Value, Example 2 Bonds Issued at a Discount, Example 3 Amortizing a Bond Discount, Example 4 Amortizing a Bond Premium. The same concepts underlie valuation of insurance reserves.

Be sure you can answer Questions 1 and 2 from Example 6 Debt Extinguishment Disclosure. For Question 2, note that the company paid 4.5 million – 2.3 million = 2.2 million. It paid  $\frac{1}{4} \times 4\% \times 4.5 \text{ million} = 45,000$  for interest, so it paid 2.2 million – 45,000 = 2,155,000 for the redemption. The 2,155,000 is also shown as a cash flow from financing activities on the financial statements. Note that interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution, such as an insurer. (The wording of this example is poor; the final exam problems more clearly distinguish between interest paid and cash paid for redemption.)

Insurers invest in long-term bonds, and often carry the investments at amortized cost. The same relation holds for interest income, interest received, changes in accrued interest, amortization of premium, and accrual of discount. A final exam problem for interest income may give

- ! the face value of the bond
- ! the annual or semi-annual coupon rate
- ! the yield to maturity of the bond
- ! the time until maturity of the bond

It might ask for the premium or discount at initial recognition and the amortization of premium or accrual of discount for a specified year.

IFRS 17 requires accretion of interest on the fulfilment cash flows and on the contractual service margin, as explained in the IFRS 17 modules. The concepts are similar to those in this module.

The module on pension costs covers § 4.

Know the types of debt covenants and their relation to financial ratios.

Final exam problems test all six ratios in Exhibit 3 Definitions of Commonly Used Solvency Ratios. Know that the financial leverage ratio uses average assets and liabilities, especially for ROA and ROE and for Dupont analysis. Example 12 Evaluating Solvency Ratios shows the calculations. The three debt ratios use end of the year values. Final exam problems test also the interest coverage ratio and the fixed charges coverage ratio. Note that EBIT is earnings before interest and taxes. For the fixed charges coverage ratio, we use earnings before interest and taxes and other fixed charges, such as lease payments.

Some final exam problems test reverse relations. A final exam problem may give the interest coverage ratio and the fixed charges coverage ratio, along with net income, and ask to derive interest payments and lease payments.