

LIABILITIES ANALYSIS

Current Liabilities

Current liabilities are amounts due for repayment within 12 months. They are usually repaid with cash generated from converting current assets during the normal operating cycle of the business. Current liabilities indicate a company's short-term ability to finance operations. In analyzing any liability, a business banker determines the following:

- To whom the money is owed
- Reason for borrowing or obligation
- Repayment terms
- Any assets pledged as collateral
- Any debt agreements in place that may restrict the business

Current liabilities include overdrafts, notes payable to banks, accounts payable, notes payable to others, due to affiliates and officers, current maturities of long-term debt, accrued expenses, and other current liabilities. Any liability with no stated maturity date, such as a demand loan, is also classified as a current liability.

Overdrafts

Overdrafts—checks written in excess of the bank deposit balance—effectively are short-term unsecured loans. If the checks, however, have not been mailed or cleared, a business will show a balance sheet overdraft on its books, while the bank does not show an overdraft on the checking account.

Accountants generally will show an overdraft as a negative cash balance. When spreading financial statements, most bankers will net any negative cash balances against any positive balances. If the net balance remains negative, the amount is reclassified as a liability and one of four following options is used:

- Show as an overdraft—This approach recognizes that the checks may be for multiple purposes
- Add to any line of credit amount—If an actual overdraft occurs at the bank, and if a line of credit is available from that bank to the business, then the checks would likely be paid via a draw on the line of credit. Some businesses utilize cash management systems where this would occur automatically
- Add to accounts payable—Businesses such as wholesalers or manufacturers with larger amounts of accounts payable are more likely to have paid on those accounts with the checks that created the overdraft. This approach effectively reverses the payments for analytical purposes, since the accounts payable balance was reduced by funds that were not really available to the business
- Add to accrued expenses—Service businesses or contractors with larger amounts of payroll or accrued expenses are more likely to have paid on those accounts with the checks that created the overdraft. This approach effectively reverses the payments for analytical purposes, since the accrued expenses (including payroll) balance was reduced by funds that were not really available to the business

Selecting from these approaches depends on the lender's knowledge of the type of business and the nature of its operating cycle and banking relationship.

READING

Notes payable to banks

This category includes short-term bank loans for periods less than one year, lines of credit, and installment loans that mature within 12 months with a balance remaining. Short-term bank loans are often for 90, 120, or 180 days, and secured by accounts receivable and/or inventory. These notes usually fund temporary or seasonal increases in accounts receivable and inventory purchases. In some cases, a short-term bank loan is used to finance multiple pieces of equipment or temporarily finance fixed assets until renewed and rewritten as a long-term loan.

For example, an owner of a lawn and garden store borrows heavily from a bank just before and during the summer season to purchase lawn mowers for resale. As the inventory of lawn mowers is sold, cash is generated to repay the loan. The store owner's notes payable to the bank would be high during the spring and summer, then low (or zero) the rest of the year.

If the note represents a line of credit, a business banker needs to determine the purpose, expiration date, interest rate, security (collateral), and other terms of the debt. Evaluating lines of credit can help a business banker understand a company's plans for bank borrowings and determine whether the loan being considered will meet anticipated financing needs. This evaluation relies heavily on the average or seasonal line usage, remaining funds available under the line, and any related loan covenants or restrictions placed on the business.

One area of confusion with notes payable involves how accountants handle installment loans that mature within 12 months with a balance remaining. In such cases, for credit or interest rate risk reasons, the bank has structured a long-term loan with maturity that precedes the full repayment. This is a common structure for loans that finance real estate such as a manufacturing plant or distribution warehouse.

Further, the bank (similar to most banks) could not offer a fixed interest rate for the full 180 months. To deal with credit risk of the customer losing a major product line and to keep the interest rate commitment short-term (to match the bank's funding sources), the bank set a three-year **balloon maturity** on the loan. Two and a half years have passed, and the store is rendering its fiscal year-end financial statement. Since the loan is maturing within 12 months from the date of the financial statement, the accountant should show the loan as a short-term note payable. If a lender anticipates that the loan will be renewed, or if a lender is dealing with an earlier financial statement and the loan has, in fact, been renewed, it should be reclassified for spreading purposes into respective long-term debt and current maturities portions at each financial statement date. Long-term debt and current maturities are discussed later in this course.

Balloon vs. bullet maturity

While lenders tend to use the terms interchangeably, there is a subtle difference.

- Balloon maturity refers to a loan that requires the remaining principal balance to be paid at a specific point in time, after some amortization of the principal balance has occurred. For example, a loan may be amortized over a fifteen year period, but requires that at the end of the fifth year the entire remaining principal balance must be paid. Most lenders use this structure if they intend to review the loan for renewal on similar terms and conditions
- Bullet maturity refers to a one-time lump-sum repayment of an outstanding loan, typically made by the borrower after very little, if any, amortization of the loan. This also refers to a loan that requires a disproportionately large portion (or even all) of the loan to be repaid at maturity. Such loans generally require periodic payment of interest prior to maturity, even if no principal amortization is being required. Most lenders use this structure if they anticipate reviewing the loan for renewal on different terms and conditions, usually tied to some other financial event happening with the borrower on or about the same time

Because each maturity structure involves a large, lump-sum amount due, they give a lender an important means of reducing interest rate risk in a loan. Most banks do not have access to longer-term sources of funding and should not take the risk of offering a long-term fixed interest rate on a real estate loan. By using a three- or five-year maturity along with a longer amortization of 15 years, a bank can offer a fixed interest rate and payment that better matches the useful life of the asset and the borrower's cash flow, while reducing the bank's interest rate risk. Even if offering a variable interest rate, the bank may need to adjust the index or spread to better match current market conditions.

A re-pricing option built into the loan structure can achieve the same pricing goals, but most lenders prefer a balloon or bullet maturity structure because it can also potentially reduce credit risk and help meet portfolio management targets. The maturity gives the lender the option to refinance the remaining balance on adjusted terms, beyond the interest rate, such as additional collateral or guarantees if the credit risk profile of the borrower has deteriorated. The interest rate, in addition to being reset to market levels, can further be adjusted to reflect the changed risk profile of the borrower.

If the borrower's risk profile is not within the lender's parameters, then the borrower can be asked to refinance that debt with another creditor, bank, or non-bank. Of course, other creditors may not offer to refinance, leaving the original bank with a difficult situation.

Similarly, even if the credit risk remains acceptable, the original lender may choose not to refinance if the loan no longer fits its portfolio management targets and goals.

Returning to the Dry Supply example, its notes payable to banks decreased. Dry Supply's very good earnings for the year, together with a stable level of accounts receivable and inventory, allowed the company to reduce its short-term borrowing needs. In fact, for over 180 days in 20xz, the company actually had a zero balance on its line of credit.

Accounts payable

Also referred to as trade credit, trade payables, or simply payables, accounts payable are amounts owed to vendors and suppliers for delivered products or services used in normal operations, and other bills that must be paid in one year or less. For many businesses, accounts payable, which represent an ongoing debt obligation, are a crucial, noninterest-bearing source of financing.

Analyzing accounts payable involves the relationship between payables and inventory, the diversity and stability of suppliers, and payment terms. Payables normally have shorter payment terms than the time the related inventory will be held by business. Therefore, the percentage change in these two accounts should be similar. As inventory levels fall or rise, so should payables. Any significant deviations should be investigated, and will likely create cash flow changes.

By obtaining a list of the company's main suppliers, a lender periodically can examine the vendor relationships. An aged listing of accounts payable will identify the name of the vendor, amount due, and length of time it has been outstanding. This list can show the numbers of vendors and any reliance (concentrations of purchases) on a narrow group of suppliers. Other considerations include credit terms and the ability of the borrower to take advantage of discounts, if any, or least staying current. In most cases where payables become delinquent, the supplier will suspend shipments, with resulting disruptions to the operations of a business.

For Dry Supply, accounts payable decreased by \$15,000 and inventory decreased by \$5,000 in 20xz. The most recent aged listing of accounts payable did not show any delinquent accounts, and there were no concentrations of purchases with a single vendor.

Notes payable to others

Notes payable to others represent amounts owed to a creditor that is neither a bank nor an investor in commercial paper. Examples include a short-term loan obtained from a commercial finance company to purchase a small piece of equipment or a note payable to a supplier to finance a seasonal increase in inventory. Commercial paper is an option for larger, publicly held companies with established credit ratings. It is an unsecured, short-term borrowing issued by companies for up to 270 days in amounts of \$100,000 or more. Although unsecured, commercial paper usually is supported by a line of credit at a bank.

Due to affiliates or officers, or loans from shareholders

These liabilities represent amounts owed by a business to its affiliated businesses or its officers. The business banker should obtain a copy of the note to determine the repayment details. Most lenders consider this account a current liability, even if repayment terms extend beyond one year, because a company's officers can get repaid first when faced with a difficult situation.

A lender can consider amounts due from related parties as **subordinated debt** (a long-term liability) when the debt is subordinated to the lender or other creditors. The underlying agreement may subordinate payment priority, lien priority, or both. If the debt is subordinated to a particular lender, and if the terms are fairly restrictive for repayment, that lender may further consider the subordinated debt to be equity, for analysis purposes. Subordinated debt will be discussed in more detail later in this reading.

Subordinated debt

Long-term debt that is paid off only after depositors and other creditors have been paid.

In any event, a business banker should investigate the purpose for the loan and terms. An increase in this account often is traced to the company expensing a large salary to its owner, who, in turn, has loaned it back to the company. This usually is done for tax considerations.

Current maturities of long-term debt

Also known as the current portion of long-term debt, current maturities of long-term debt (CMLTD) is the principal portion of long-term or installment debt that will be paid within one year. For example, at the fiscal year-end of a business a \$400,000 loan for manufacturing equipment is outstanding. The loan is to be paid in 48 equal monthly installments of principal, plus interest due. Of the \$400,000 total loan amount, \$100,000 is due within one year and is listed at fiscal year-end as CMLTD. In situations where there is a level payment of combined principal and interest, the CMLTD amount at any financial statement date will be based on an amortization schedule of the loan.

Installment debt analysis includes identification of its repayment terms, maturity schedules, conditions, security (collateral), and creditors. Debt financed with balloon or bullet maturities faces the possibility that in future years current maturities might increase substantially. The lender must determine whether future earnings can repay balloon notes and, if not, what refinancing provisions have been made. Covenants written into the balloon note's agreement might be triggered by certain events that cause the debt to be accelerated and become due and payable. For example, the debt might become due immediately if the company fails to meet certain profit levels.

Business tax returns combine notes payable and CMLTD as a single line item within the balance sheet or Schedule L in the tax returns.

Accrued expenses

Accrued expenses (sometimes called accruals) are operating expenses and other expenses recognized on the income statement but not yet paid, or paid in arrears. They include various operating expenses that have not been allocated to cost of goods sold (and inventory). For many companies the largest accrued expense is for payroll and related benefits. Operating expenses paid for in advance, such as rent and insurance, become **prepaid expenses**, an asset account. Generally, accrued expenses exclude income taxes payable and deferred taxes, which have separate accounts. Business tax returns do not have a separate line item for accrued expenses, so they are generally included with *other current liabilities* on Schedule L.

Prepaid expenses

A classification of expenditure made to benefit future periods. Such items are classified as current assets and constitute a part of a firm’s working capital. Prepaid expenses include prepaid rent, certain taxes, royalties, and unexpired insurance premiums.

Other current liabilities

The amounts reported in other current liabilities usually are not material. Some of these incidental items include deposits received before products are manufactured or shipped.

The balance sheet spread for Dry Supply below shows the current liability accounts for December 31, 20xx, 20xy, and 20xz.

Current Liabilities: Dry Supply (\$ in 000s)			
As of December 31,	20xx	20xy	20xz
Notes payable-bank	\$ 81	\$ 12	\$ 22
Accounts payable-trade	42	113	112
Accrued taxes	5	72	67
Accrued bonuses	10	0	0
Total current liabilities	\$138	\$197	\$201

Although the company’s short-term bank debt and accounts payable have declined, a business banker should examine the inventory account to see if it also declined and how the company repaid the debt. In addition, the company has \$19,000 of accrued liabilities in 20xz. A lender should determine when these liabilities need to be paid and the source of funding for the repayment. As with current assets, business tax return formats do not provide a subtotal for current liabilities.

READING**Noncurrent Liabilities**

Noncurrent or long-term liabilities are amounts due beyond one year. They include long-term debt, bonds and debentures, subordinated debt, and reserves. With any long-term obligation, the portion of debt due within one year is classified separately as a current liability.

Unlike current liabilities, which generally are repaid by the conversion of current assets to cash, long-term liabilities are usually repaid from excess cash generated over a series of operating cycles. Therefore, an assessment of future profitability accompanies any evaluation of a business's ability to sustain repeated operating cycles to support its long-term obligations. Further, long-term liabilities are evaluated for terms, purposes, interest rates, security (collateral) pledged, and whether current levels supply adequate financing support for fixed assets or permanent working capital levels.

Long-term debt

Land, buildings, equipment, and permanent increases in levels of inventory and receivables are among the items financed with long-term debt. Loans secured by land and buildings are also called mortgage loans or deed of trust loans, and generally they are repaid over 15 to 20 years. Equipment usually is financed over the shorter of depreciable life or the useful life, which is generally 3 to 10 years. Permanent increases in inventory and accounts receivable normally are financed over 3 to 5 years.

When incurring long-term debt, most businesses are required to enter into a loan agreement that essentially supplements the basic terms and conditions in the note. The addition provisions can include financial covenants and other expectations of the business over the loan term. Most long-term loans are secured by collateral because the longer the term of the loan, the higher the risk. Also, because these loans often finance or refinance the purchase of assets, the assets are available as collateral.

Only companies with exceptionally strong balance sheets and consistent profits merit a long-term, unsecured note.

Bonds and debentures

Bonds are interest-bearing or discounted certificates of indebtedness, paying a fixed rate of interest to the creditors or holders over the life of the obligation. Maturities generally are longer than five years. Debentures are unsecured promises to pay backed by the general credit of the issuer. Some debentures can be exchanged for common stock at a specific price. In terms of the financing they provide for a company, bonds and debentures function the same long-term debt; however, bonds and debentures are securities that can be traded by investors and having a market value. Level 1 Course 2 of the curriculum covers industrial revenue bonds, a form of tax advantaged financing often available to customers of community banks.

READING

Subordinated debt

Subordinated debt is a liability having a lien against the borrower's assets that is secondary (or junior) to other obligations or a claim for payment, only after holders of the primary (or senior) debt obligations are paid. When debt is subordinated, an agreement is created that stipulates whether nothing, or a limited amount of principal and interest, will be paid on the subordinated debt until the terms of certain other debts are satisfied.

Most lenders use the subordinated debt category, for spreading purposes, only for debts subordinated to the lender and under acceptable conditions. If the debt is from the officers or owners of the business, and adequately subordinated, some banks add the amount to total equity when calculating tangible net worth. For example, a bank may, as a condition of extending credit to a business, specify that any loans from the owners be subordinated to the bank's loans. Payments on the owner loans are prohibited as specified in the subordination agreement. Also, in a liquidation, the bank will be repaid in full before any payment is made on the subordinated debt. The subordinating of collateral results when one lien holder takes a junior position to another lien holder and it is often a key feature of a subordination agreement.

In lending to a privately held company, it is often required that any owner debts be subordinated, because the company's owners have the ability to pre-pay these loans, regardless of the written commitment in place between the owners and the business. To effectively freeze these loan amounts, the original note(s) signed by the business are held by the bank, along with a subordination agreement establishing when and how these loans can be repaid.

Long-term debt, bonds/debentures and subordinated debt can be shown together on a business tax return as mortgages, notes, bonds payable in 1 year or more. If subordinated debt is from a shareholder, it should be listed as "loans from shareholders" account on Schedule L.

Reserves

Although not a formal debt owed to any one or several creditors, reserves are recognized as a long-term liability because they represent an obligation that theoretically must be met some time in the future. Two more common uses of reserves are to pay deferred income taxes and provide product warranties.

Deferred income taxes arise when a business uses one depreciation method for tax reporting that accelerates depreciation expense faster than another method used for preparing financial statements. It is accepted by GAAP to prepare financial statements and tax returns using different depreciation methods. Product warranties arise when a business guarantees its product for a period of time. The estimated costs to repair a product under warranty are classified as a long-term liability usually labeled "warranty reserves."

Referring to Dry Supply's balance sheet for 20xx, 20xy and 20xz, its total for long-term liabilities consists of a single line item—subordinated debt-officers—of \$48,000, \$58,000, and \$67,000, respectively. With the liability portion of the balance sheet equation now complete, the composition of current and noncurrent liabilities is as follows:

Current Liabilities + Noncurrent Liabilities = Total Liabilities (\$ in 000s)			
December 31, 20xx:	\$138	+ \$48	= \$186
December 31, 20xy:	\$131	+ \$58	= \$189
December 31, 20xz:	\$109	+ \$67	= \$176