

1. The two major sources of uncertainty for liabilities that can cause their payments to be abnormally high or low are interest rate risk and default risk.
2. GAAP for liabilities are largely historically based because changes in the value of liabilities related to changes in interest rates or default risks are typically not recognized. Therefore, the liabilities will generally be recorded at their original historical cost.
3. Long-term liabilities include loans, leases, mortgages, and deferred compensation arrangements.
4. Financial instrument agreements are contracts between borrowers and lenders that typically specify:
 - a.) A schedule of payments that the borrower promises to make to the lender.
 - b.) A set of restrictions on the borrower's actions, the violation of which puts the borrower in default.
 - c.) A definition of the borrower's and lender's rights if there is no default.
 - d.) A definition of the lender's and borrower's rights if the borrower defaults.
5. The coupon rate is the percentage applied to the face value of the bond that is used to determine the annual interest payments of the debt instrument.
6. Most notes promise annual interest payments and return of principal at maturity.
7. A floating rate note is one whose interest rate may change over time. Usually it is pegged to some index.
8. LIBOR stands for London Inter-bank Offer Rate and is the interest rate that most international banks charge one another for overnight loans.
9. A covenant is a restriction or financial condition placed on the borrower's actions in a loan arrangement.
10. A positive covenant would require a borrower to maintain certain financial conditions or ratios; a negative covenant restricts the borrower's actions.
11. The current ratio is computed by dividing total current assets by total current liabilities.
12. A technical default is the failure of a borrower to maintain the requirements of a positive loan covenant.
13. Callable bonds give the issuer the right to repurchase them from the holder at a specified time for specified prices.
14. Convertible bonds give the holder the right to convert the bond into some other type of financial instrument, such as common stock, according to specified conditions and specified terms.
15. A secured financial instrument gives a lender collateral in certain assets

of the borrower that can be seized if the borrower defaults; an unsecured instrument relies on the general creditworthiness of the borrower for their repayment.

16. Seniority specifies the order in which claims are to be paid if default occurs. Senior debt must be paid before junior debt.
17. Recourse gives the lender the right to look to another party for repayment if the borrower defaults.
18. The annual economic rate of return to the holders of bonds priced to yield 10%, compounded semiannually is 10.25%, since $(1.05) \times (1.05) = 1.1025$.
19. If interest rates fall, bond prices will rise. The economic value of a bond yielding 7% will increase if market interest rates fall to 6.5%.
20. While changes in market interest rates will cause the economic value of bonds to change, this change in value is not recognized by GAAP. Accounting for bonds is driven by the historical interest rate.
21. Discount on bonds payable is a contra-liability account that is netted against the Bonds payable account to arrive at the net bond liability on the balance sheet.
22. A lease that is considered a rental agreement is called an operating lease. A lease that is considered a purchase is called a capital lease. The obligation to pay all future lease payments is shown on the balance sheet for a capital lease.
23. If a lease meets any one of three criteria, it is classified as a capital lease. The criteria are:
 - The lease lasts for at least 75% of the expected useful life of the leased property.
 - The present value of the lease payments is at least 90% of the value of the property.
 - The lease contains a bargain purchase clause that allows the lessee to buy the asset at below market price at any time during the lease.
24. While the gain on retirement of bonds will increase a company's accounting income, there may be no economic gain on the exchange of cash flow streams if the company issues new bonds after retiring the old bonds and transaction costs will be incurred.
25. Times-interest-earned is earnings before interest and taxes divided by interest expense.
26. Off-balance-sheet financing refers to any borrowing or financial obligations of the company that are not required by GAAP to appear on the company's balance sheet (e.g., operating leases).
27. A zero coupon bond is a security where a lump sum is received at the

beginning and no interest or principal payments are paid until maturity.

28. A zero coupon bond will sell at a deep discount to face value, since the only future cash payments are its maturity value. The present value of the principal payment will always be less than the future value.

