Unit 4 Financing a Business With Liabilities

I. Introduction

A. Unit 3 explained how assets are financed **with equity**.

B. This unit explains how assets are financed **with liabilities** (debt).

II. Accounts Payable

A. These informal oral obligations are incurred to buy merchandise, supplies, services, and other common everyday items.

B. Similar liabilities, important enough to be given their own name, include Wages Payable, Rent Payable, Taxes Payable, and Interest Payable.

III. Notes Payable

A. A **note payable** is a written statement of the conditions of a loan.

B. **Loan conditions**

1. **Principal (P)** is the amount of the loan.
2. **Time (n)** is the length (term) of the loan.
3. **Interest rate (i)** is the percentage paid or earned on the principal.
   a. Interest is normally stated annually.
   b. A three month loan (one-fourth of a year) at 8% would require that 2%, (8%÷4), be paid on the principal.
4. Loans often require collateral.
   a. **Collateral** is something of value that must be forfeited if a loan is **defaulted** on (not paid back).
   b. A **mortgage** states the parties' agreement concerning collateral.

C. Calculating interest

1. **Interest** is either the cost of borrowing or the benefit of lending.
2. The interest paid on a $7,000,000 loan at 12% for six months would be calculated as follows:

Interest = (principal)(interest rate)(time)

$I = pin$

$= (\$7{,}000{,}000)(.12)(\frac{6}{12}) = \$420{,}000$

IV. Bond Financing

A. When a large amount of debt financing is required, a **bond issue**, described with a **bond indenture**, may be used.

B. A bond issue consists of many notes payable having the same conditions.

C. A company may raise $7,000,000 by selling 1,400 bonds with a **par (face) value** of $5,000.

D. Bond interest

1. The specified annual rate **paid on the par value** of a bond is called the **nominal interest rate.** Other names for this rate include stated, coupon, and contract.
2. Bonds often sell below or above par.
   a. A bond's **nominal interest rate** is stated on the bond, used to determine interest paid on the bond, is determined months before the bonds will be sold, and based on these factors:
      1) Debt market conditions at the time the bond indenture is written
      2) An estimate of what potential bond buyers think about the financial condition of the company borrowing the money
   b. If debt market conditions worsen (interest rates increase) and/or the financial condition of the company worsens, a bond will sell at a **discount (below par)**. Since the company receives less than face value, the **effective interest rate** they pay is higher than the bond's nominal rate.
      1) A $5,000, 12% bond pays interest of **I = Pin** = $5,000(.12)(1) = $600/year.
      2) If market conditions worsen and the company receives only $4,900, the effective interest rate would be 12.2%.
   c. If debt market conditions improve (interest rates decrease) and/or the financial condition of the company improves, a bond will sell at a **premium (above par)**. This means the company would pay an effective interest rate below 12%.

$$\frac{I}{\text{Amount Received}} = \frac{\$600}{\$4{,}900} \approx 12.2\%$$

V. Financial Markets

A. Stocks and bonds are called financial securities. They are originally sold by financial companies to customers in the **primary financial markets**.

B. These financial securities may then be sold and resold many times in the **secondary financial markets**.

1. The **Dow Jones Industrial Average** is the technically adjusted total selling price of 30 very well known companies (IBM, ATT, etc.) listed on the New York Stock Exchange. These stocks were originally sold many years ago for a much lower price.
2. A 30-year bond selling 2% above par is quoted in the financial markets as selling for 102. This means a $10,000 bond listed at 102 is selling for 1.02 x $10,000 = $10,200.