Installment Notes Payable and Accounting for Long-Term Notes Payable

The use of notes payable in long-term debt financing is common. Accounting for long-term notes payable is similar to accounting for a short-term interest bearing notes payable except the term is longer than one year. They both are based on installment payments. The terms require the borrower to make equal installment payments over the term of the loan. Each payment consists of (1) interest on the unpaid balance of the loan, and (2) a reduction of loan principle. While the total amount paid remains constant, the interest decreases each period and the portion applied to the loan principle increases. Companies initially record mortgage at face-value, and subsequently make entries for each installment payment. If there is a down cash payment you must reduce the face amount by the down payment before you record the notes payable, therefore you only record the unpaid principle balance as a payable. The initial down payment is recorded in the cash account. See the following example.

On December 31, 2011, ELM Corporation signed a 20 year, 8% $400,000 mortgage note to obtain financing to build a new building. The terms of the note requires semiannual installment payments of $22,250 (not including estate taxes and insurance). The installment payment schedule shown below is only for the first 2 years of the 20 year term.

Date	Semiannual interest period	(A)=Cash payment (stays the same)	(B)=Interest Expense =(D) * 4%	(C)=Reduction of Principle = (A) - (B)	(D)=Unpaid principle Balance = (D) - (C)
					400,000
12/31/11	1	22,250	16,000	6250	393,750
06/30/12	2	22,250	15,750	6500	387,250
12/31/12	3	22,250	15,490	6760	380,490
06/30/13	4	22,250	14,220	7030	373,460

Column Calculations:

(A) The cash payment of $22,250 is constant every 6 months or semiannual.

(B) The annual interest rate is 8%, however because interest payments are made semiannual are twice a year we can use of 4%. The interest for the first installment is $400,000 x 4%=$16,000. Each interest payment is calculated by multiplying the unpaid principle balance times the 4% rate.

(C) The reduction of principle is calculated by subtracting the interest payment of $16,000 from the cash payment of $22,500. The results being $6250.

(D) The unpaid principle balance is calculated by subtracting the principle reduction amount of $6250 from the original unpaid principle balance of $400,000. The resulting amount is $393,750, which is the new unpaid principle amount. The new of $393,750 is used to compute the next interest payment amount. ($393,750 x 4%= 15,750).

The journal entries related to the above transaction will be as follows.

(1) Dec 31, 2011 when the note was first signed for $400,000 to bring it on the books.

Dec 31

Cash-	400,000	
Mortgage Note Payable-		400,000

(2) The following entry must be recorded with each payment mode. We use the first payment made on 6/30/12.

June 30

Interest Expense-	16,000	
Mortgage Note payable –		6250
Cash-		22,250