



# AFS Profit

*Your Guide to  
Small Business  
Success*

## Bonds Payable

## Bonds

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Bonds are a form of long-term debt for the issuer. (For the buyer of the bonds, the bonds are an investment.)

## Bonds Payable

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As part of the entry to record the issuance of bonds, the issuer will record the face value of the bonds in a long-term (or noncurrent) liability account entitled Bonds Payable.

Typically the issuer of the bonds agrees to pay the bondholders:

- interest every six months (semiannually), and
- the face or maturity value when the bonds come due

## Why Bonds? Why Not Common Stock?

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Bonds are different from common stock in that *usually*:

- the issuer of the bonds does not give the bondholders any ownership interest
- the semiannual interest payments must be made when due
- the maturity amount must be paid when the bonds come due
- the issuer's interest expense qualifies as an income tax deduction (whereas dividends are not tax deductible)

The above features will mean that money raised from issuing bonds will be less costly than the money raised from issuing shares of common stock.

## Face Value of Bonds

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The amount appearing on the face of the bonds is also known as the following:

- face value
- par value
- principal amount
- stated value
- maturity value

## Interest Rate on Bonds

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The interest rate shown on the face of the bonds is the *annual* interest rate that will be used to determine the semiannual interest payments. This interest rate is also known as:

- face interest rate
- stated interest rate
- contractual interest rate
- nominal interest rate
- coupon interest rate

Typically, this interest rate will not change and is therefore considered to be a *fixed rate*. This will result in the semiannual interest payments being the same amount, calculated as: face interest rate X face value of the bond X 6/12 of a year.

## Market Interest Rates

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We stated that the bonds' semiannual interest payments and maturity value are both fixed in amount. However, the *market interest rates* for similar bonds seem to be changing daily due to events occurring throughout the world. The market interest rate is also known as:

- effective interest rate
- yield-to-maturity
- discount interest rate
- desired interest rate

## Market Interest Rates and the Value of Existing Bonds

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When market interest rates *decrease*, the value of existing bonds will *increase*. The reason is the *fixed amounts of the cash payments* (interest and maturity value) will become more attractive and therefore *more valuable*.

When market interest rates *increase*, the value of existing bonds will *decrease*. The reason is the fixed cash payments for interest and maturity value have now become less attractive and therefore *less valuable*.

To recap, the *market value* of existing bonds will move in the opposite direction of the change in the *market interest rates*.

## Bonds Sold at Par Value

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When a corporation offers bonds having a stated interest rate of say 8% and the market interest rate for similar bonds is 8%, the bonds will sell at their par or maturity value. Bonds selling at their par value are said to be sold at 100, which means 100% of the bonds par value. Hence, a \$100,000 bond will sell for \$100,000 and will be recorded as follows:

Cash	\$100,000
Bonds Payable	\$100,000

## Bonds Sold at a Discount

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If bonds having a stated interest rate of 8% are offered on a day when the market interest rate is 8.2%, the bonds will sell for *less than* their par or maturity value. In other words, the bonds might sell for 98 or 98% of face value. Therefore, a \$100,000 bond will sell for \$98,000. Assuming there is no accrued interest on the date the bond is issued, the journal entry for the issuance of the bond will be:

	Cash	\$98,000
	Discount on Bonds Payable	\$2,000
Bonds Payable		\$100,000

Discount on Bonds Payable is a contra-liability account which is always presented with Bonds Payable. Hence, the book value or the carrying value of the bonds payable is \$98,000 (\$100,000 minus \$2,000). Over the life of the bonds, the discount on bonds payable must be amortized to interest expense.

## Bonds Sold at a Premium

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If bonds having a stated interest rate of 8% are issued on a day when the market interest rate is 7.9%, the bonds will sell for *more than* the par value or maturity value of the bonds. In other words, the bonds might sell for 101 or 101% of face value. Therefore, a \$100,000 bond would sell for \$101,000. Assuming there is no accrued interest on the date the bond is issued, the journal entry for the issuance of the bond will be:

Cash	\$101,000
Premium on Bonds Payable	\$1,000
Bonds Payable	\$100,000

Premium on Bonds Payable is an adjunct liability account which is always presented with Bonds Payable. Hence, the book value or the carrying value of the bonds payable is \$101,000 (\$100,000 plus \$1,000). Over the life of the bonds, the premium on bonds payable must be amortized to interest expense.

## Straight-line Amortization of Discount or Premium

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If the amount of the discount or the premium on bonds payable is not significant, the corporation may amortize the discount or premium using the *straight-line method of amortization*. This means the same amount of amortization will be recorded each year.

## Effective Interest Rate Method of Amortizing Discount or Premium

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If the amount of the discount or the premium is significant, the initial amount of the discount or premium should be reduced by using the *effective interest rate method of amortization*. Under this method the *market interest rate* on the date that the bonds were issued is multiplied times the *book value* (carrying value) of the bonds at the start of each six-month period. The resulting amount is the amount debited to Interest Expense for the six-month period. The difference between the interest expense and the actual interest payment is the amount of the Discount or Premium that is being amortized in the current period. (The *book value or carrying value* of bonds is the combination of the balance in Bonds Payable and the balance in the Discount on Bonds Payable account or in the Premium on Bonds Payable account.)

## Accrued Interest on Bonds Payable

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Since most bonds pay interest semiannually, the issuer of the bonds will have *accrued interest expense* and *accrued interest payable* on the other 363 days of the year. For example, if on June 1 a corporation issues \$3,000,000 of bonds with a stated interest rate of 6% (and the market interest rate is also 6%), the corporation will be incurring interest expense of \$180,000 per year; \$15,000 per month; \$500 per day. This means that on June 30, the corporation must debit Accrued Interest Expense for \$15,000 and credit Accrued Interest Liability for \$15,000. When the corporation makes its December 1 interest payment of \$90,000 the balance in Accrued Interest Liability will be \$0 for that day.