

# ACCT 101, Session 8: Long Term Liabilities

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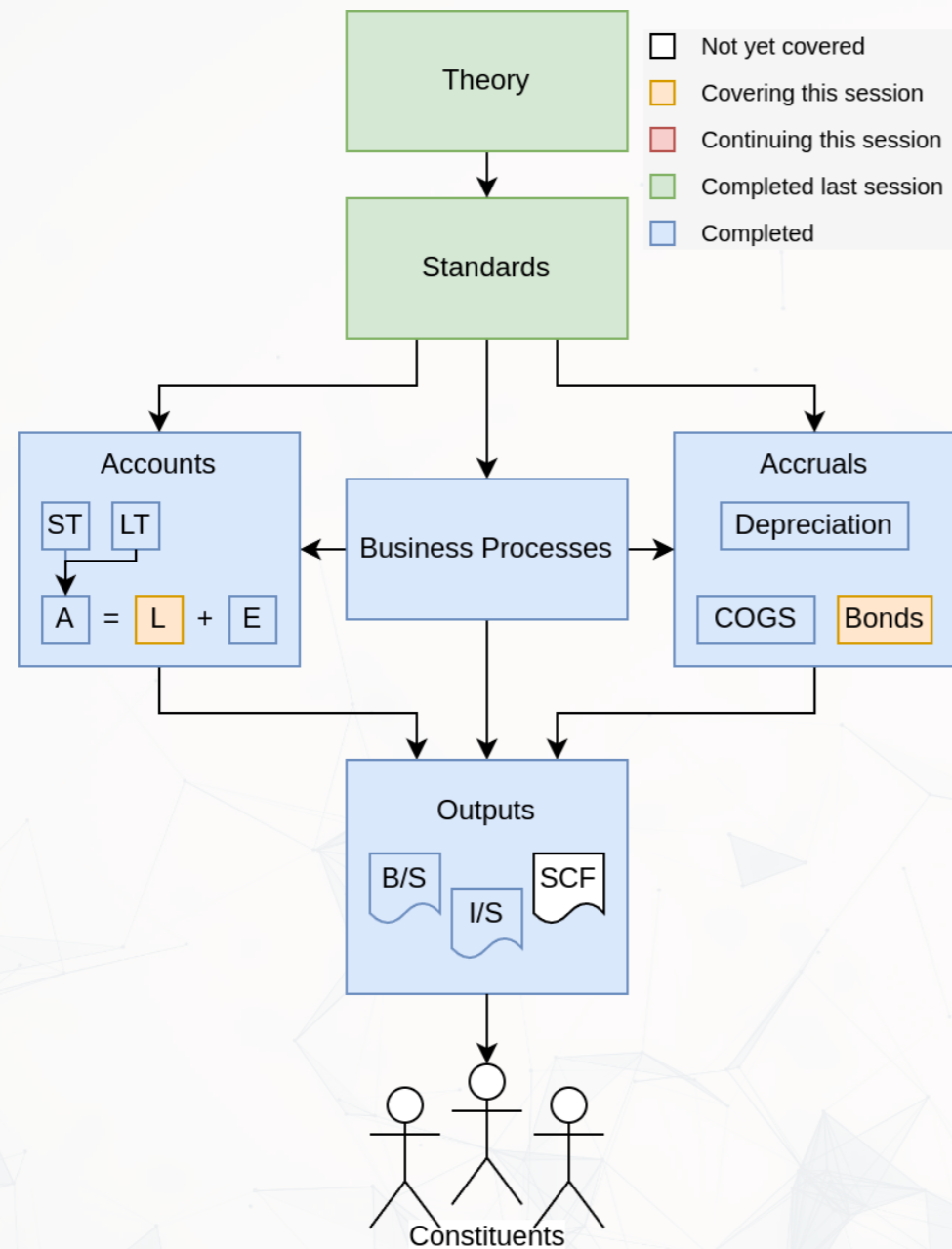
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# Front matter

# Quiz 2

- Covers everything since Quiz 1
  - Inventory
  - PP&E
  - Intangibles
  - Liabilities
  - Bonds
- For calculations, the level of rounding will be specified
- Same format as Quiz 1
  - Practice quiz and additional practice are on eLearn

# Learning objectives



## Liabilities (Chapter 9)

1. Account for bonds at par
2. Account for bonds not at par
3. Account for bond buybacks

# Bonds

The background is a dark blue gradient with several diagonal lines of varying thickness and shades of blue. On the right side, there are scattered, semi-transparent geometric shapes including squares, rectangles, and small clusters of dots, creating a digital or data-like aesthetic.

# What is a bond?

- An interest bearing note payable
- Issued by a company in a manner similar to stock
  - Often to investors (like stock)
  - Trades on an exchange daily (like stock)
  - Does not offer ownership
    - For the simpler bonds we'll cover in this course
- Usually due in 5 or 10 years, frequently longer
- Interest is usually paid every 6 months



# Types of bonds

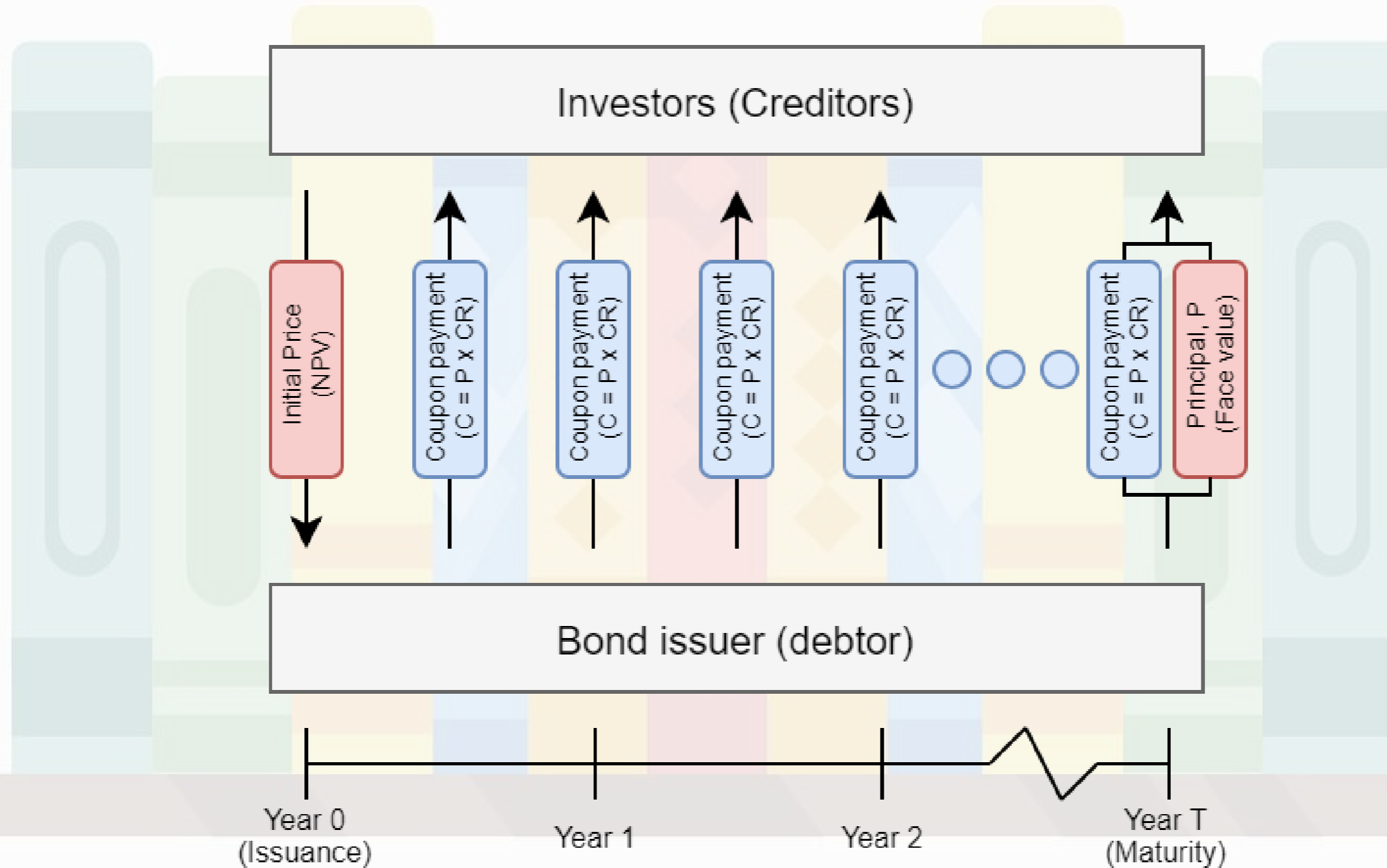
- Backing
  - Secured bonds: Backed by assets such as real estate (mortgage bonds) or other assets (collateral trust bonds)
  - *Unsecured bonds*: No asset backing; also called debentures
- Principal Payments
  - *Term Bonds*: Mature on a single date
  - Serial bonds: Pay off principal in installments
- Other features
  - Convertible bonds can be converted into common stock at the creditor's request
  - Callable bonds can be paid early at a stated amount prior to maturity at the debtor's request

You only need to price **unsecured term bonds** in this course

# Bond characteristics

- From the bond holder's perspective
  - Higher precedence than stock during bankruptcy
  - No voting rights
  - No ownership
- From the bond issuer's perspective
  - Interest payments are tax deductible
  - Guaranteed cash outflows
  - Raises funds without giving up ownership

# Life of a bond



# Bond terms

- Term: length of time of the bond
- Maturity date: when the bond is due
- Par value: The amount the bond will pay at maturity
  - Aka: principal amount, maturity value, face value
- Coupon rate: Yearly % of interest paid
  - Aka: Stated interest rate, nominal rate
- Yield: Yearly percent return if you purchase the bond today
  - This was our discount rate last week
  - Aka: Market interest rate, effective interest rate
- Price: % of par value you need to pay to purchase
  - $100 \Rightarrow$  Full price, "At par"
  - $< 100 \Rightarrow$  Discount
  - $> 100 \Rightarrow$  Premium

# Bond quote terms

- CUSIP: Unique identifier given to the bond
  - Ex.: [345277AE7](#), [345370CA6](#), [345370BH2](#)
- Name: Name given to the bond
  - Usually the debtor's ticker symbol followed by a bond-specific portion
    - [F.GD](#), [F.GY](#), [F.GI](#)
- Day count: 30/360 or actual
  - *30/360*: Assumes 30 days per month, 360 days per year
    - Most common day count for bonds
    - Easier to calculate
  - Actual: Count the number of days

## Where to get bond data

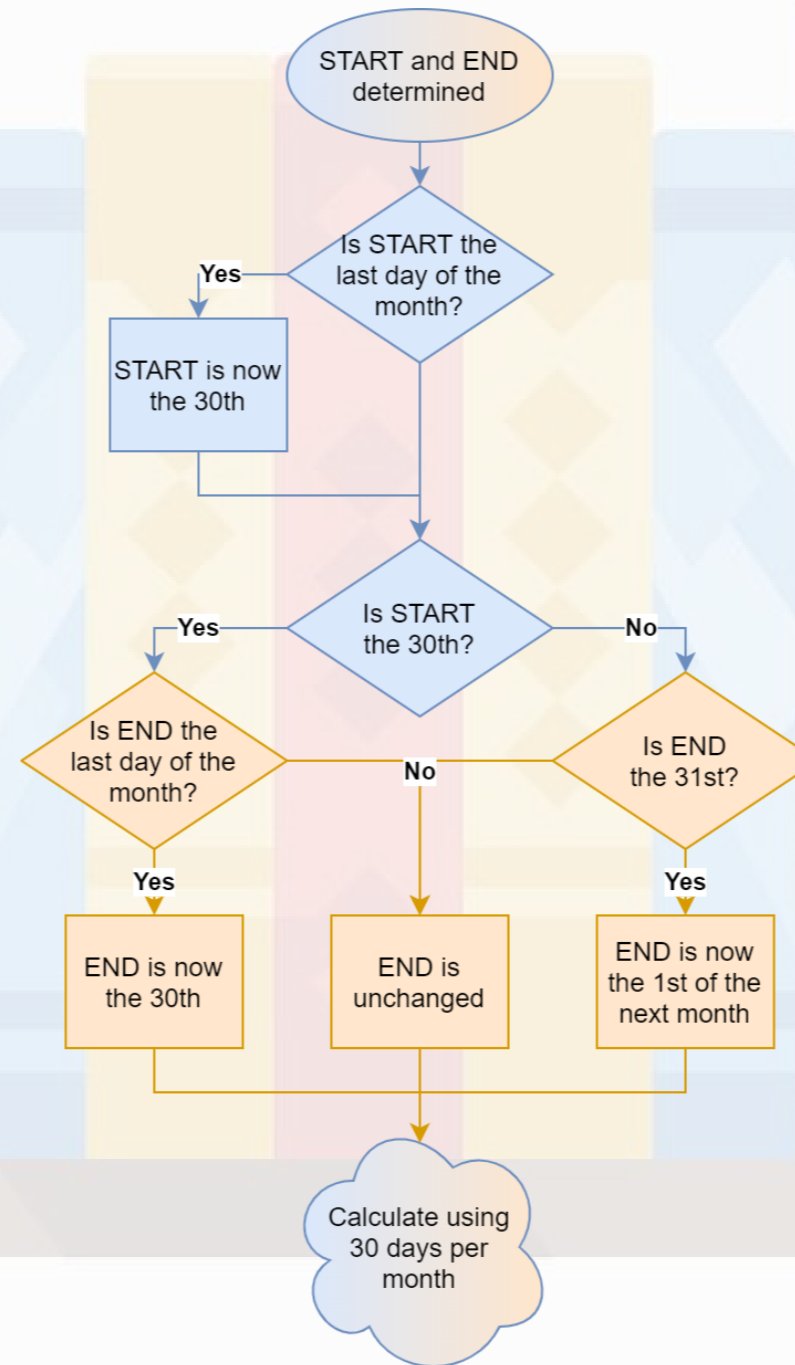
Bond quotes available at [Finra.org](https://www.finra.org), but certain details require subscriptions (the LKS Library has)

# How to do day counts

- Actual/Actual day count:
  - Use the actual number of days divided by the number of days in the year (365 or 366)
- 30/360 day count:
  - Full months have 30 days each
  - Full years have 360 days
  - If the starting date is the last day of the month, call it the 30th
  - If the adjusted starting date is the 30th, then if the ending date is the last day of a month, call it the 30th as well
    - If not, the 31st becomes the 1st of the next month
    - If not, the 28th or 29th (February) stays where it is

Example: Between June 20th and August 25th, there are actually 66 days.  
Using 30/360, we say there are 65 days

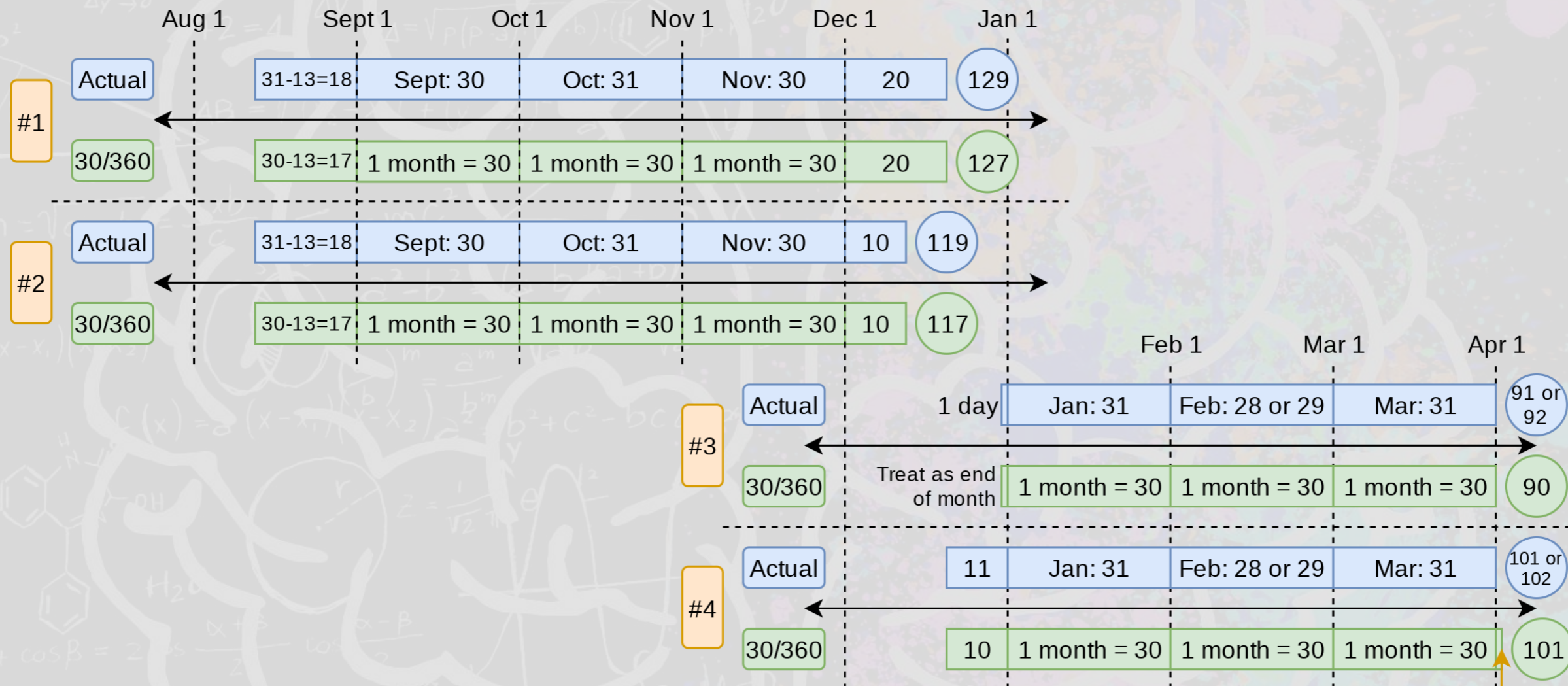
# How to do day counts



# Day counts, 30/360

1. How many days are there between August 13th and December 20th?
2. How many days are there between August 13th and December 10th?
3. How many days are there between December 30th and March 31st?
4. How many days are there between December 20th and March 31st?

# Day counts, 30/360



Treat March 31st as April 1st, since start is not a month end. 1 day.

# Valuing bonds

The background is a dark blue gradient with several diagonal lines of varying shades of blue on the left side. On the right side, there are scattered, semi-transparent geometric shapes including squares and small clusters of dots, creating a digital or data-like aesthetic.

# Recap of NPV

- We had 2 formulas last week that will help us calculate bond values
  - Single cash flow in the future:  $NPV = \frac{CF}{(1+r)^T}$
  - Repeated cash flow (annuity):  $NPV = \frac{CF}{r} \cdot \left[ 1 - \frac{1}{(1+r)^T} \right]$
- From an investor's perspective, a bond is:
  - An initial payment (outflow)
  - An annuity received every 6 months (inflow)
    - Annuity: Receiving the same cash flow every period for a set number of periods
  - A final cash flow (inflow)
- Investors pay the NPV of a bond when discounting by the *yield*

# Let's value a bond!

- The bond: [MSFT.GG](#)
  - Microsoft issued on September 27, 2010
  - 10 year bond
  - 3.10% yield when it was issued
  - 3.00% coupon rate
  - Semiannual coupon payments (interest payments)
  - 30/360
  - \$1B par value, in total
- One trick needed:
  - Since this (and most other) bonds pay their interest *semiannually*, we need to calculate using half-years

# Using our NPV formulas

How much would investors pay for the bond?

- Principal,  $P$ , is \$1B
- Annuity cash flow = 3.00% of principal per year, paid in 2 payments
  - $3\% \times \$1B = \$30M$  per year, so  $CF = \$15M$  semiannually
- Discount rate = yield = 3.10%,  $r = \frac{3.10\%}{2} = 1.55\%$  semiannually
- Number of *semiannual periods*,  $T = 20$

# Using our NPV formulas: Annuity

- $P = \$1B, CF = \$15M, r = 1.55\%, T = 20$

Annuity portion

$$\begin{aligned} \text{Annuity NPV} &= \frac{CF}{r} \cdot \left[ 1 - \frac{1}{(1+r)^T} \right] \\ &= \frac{15M}{0.0155} \cdot \left[ 1 - \frac{1}{(1+0.0155)^{20}} \right] \\ &\approx \$256M \end{aligned}$$

# Using our NPV formulas: Principal

- $P = \$1B, CF = \$15M, r = 1.55\%, T = 20$

Final cash flow (principal)

$$\begin{aligned} \text{Principal NPV} &= \frac{P}{(1+r)^T} \\ &= \frac{\$1B}{(1+0.0155)^{20}} \\ &\approx \$735M \end{aligned}$$

# Using our NPV formulas: Principal

- $P = \$1B, CF = \$15M, r = 1.55\%, T = 20$

Bond price, i.e., bond NPV

$$\begin{aligned} NPV &= \text{Annuity NPV} + \text{Principal NPV} \\ &= \$256M + \$735M \\ &= \$991M \end{aligned}$$

- This means that investors paid \$991M for the bond issue when it was issued.

## 💡 Technical note

If you solve this more precisely, you will get an answer \$.01M off from the original issue price, as the bond was actually a 10 year and 3 day issue. We will ignore those 3 days. We won't deal with these fractional years for bond pricing.

# Simplifying our equation

- We can bring everything together into 1 equation:

$$Price = \frac{CF}{r} \cdot \left[ 1 - \frac{1}{(1+r)^T} \right] + \frac{P}{(1+r)^T}$$

- Variables:
  - $P$ : Principal amount, aka the par value
  - $i$ : Coupon rate
  - $y$ : Yield
  - $Y$ : Length of bond, in years
  - $n$ : Number of payments per year
- Then:
  - $CF = \frac{P \times i}{n}$ : Cash flow per coupon
  - $T = Y \times n$ : Number of payments
  - $r = y/n$ : Discount rate

# Applying the equation to our bond

$$Price = \frac{CF}{r} \cdot \left[ 1 - \frac{1}{(1+r)^T} \right] + \frac{P}{(1+r)^T}$$

- Given:

- $P = \$1B$ ,  $i = 3\%$ ,  $y = 3.10\%$ ,  $Y = 10$ ,  $n = 2$

- Calculate:

- $CF = \frac{p \times i}{n} = \frac{\$1B \times 3\%}{2} = \$15M$

- $T = Y \times n = 10 \times 2 = 20$

- $r = y/n = 3.10\%/2 = 1.55\%$

$$Price = \frac{\$15M}{0.0155} \cdot \left[ 1 - \frac{1}{(1 + 0.0155)^{20}} \right] + \frac{\$1B}{(1 + 0.0155)^{20}}$$
$$\approx \$991M$$

# What about the table method?

- The table method is allowed on the final exam, and annuity and NPV tables will be provided
- Table equation:  $Price = CF \times Annuity\_factor + P \times NPV\_factor$ 
  - *Annuity\_factor* comes from the cell in the annuity table corresponding to  $T$  periods and  $r$  discount rate
  - *NPV\_factor* comes from the cell in the NPV table corresponding to  $T$  periods and  $r$  discount rate

The *equation method* is more accurate, works for any  $r$  and  $T$ , and can also be used in your other classes

# Practice

- Bond: McDonald's [MCD4248394](#)
  - Principal of \$700M
  - Coupon rate of 3.375%
  - Yield of 3.39%
  - 5 year bond
  - Semiannual coupon payments

What is the price?

# Solution

- $P = \$700M$
- $CF = \$700M \times 3.375\%/2 \text{ per year} = \$11.8125M$
- $T = 5 \text{ years} \times 2 \text{ per year} = 10 \text{ half-years}$
- $r = 3.39\%/2 \text{ per year} = 1.695\%$

$$\begin{aligned} \text{Price} &= \frac{CF}{r} \cdot \left[ 1 - \frac{1}{(1+r)^T} \right] + \frac{P}{(1+r)^T} \\ &= \frac{\$11.8125M}{0.01695} \cdot \left[ 1 - \frac{1}{(1+0.01695)^{10}} \right] + \frac{\$700M}{(1+0.01695)^{10}} \\ &\approx \$699.52M \end{aligned}$$

# Accounting for bonds: Par

# Accounting for bonds

## What we need to know

- Principal
- Price (we can solve for this if not given)
- Yield
- Coupon amount (or rate)
- Coupon payments per year
- Count basis (30/360 usually)

## Steps to account for

1. Account for bond issuance
2. Account for coupon payments
3. Account for accrued interest expense at year end
4. In the final period, pay back the principal

## Types of bonds

- Bond *at par*: Coupon rate = yield  $\Leftrightarrow$  price = par value
- *Discount* bond: Coupon rate < yield  $\Leftrightarrow$  price < par value
- *Premium* bond: Coupon rate > yield  $\Leftrightarrow$  price > par value

# Bonds at par

- Example bond for these slides:
  - Principal = \$100M
  - Price = \$100M
  - Yield = 5%
  - Coupon rate = 5%
  - Semiannual coupon payments (every 6 months)
  - Count basis: 30/360
- Assume it's a 10 year bond issued on March 10th, 2018
- Assume the firm issuing the bond uses a Dec 31 year end

We will treat this very similarly to a note payable, except there are interim interest payments

# Bonds at par: Issuance

- Step 1: Account for bond issuance

## Example: Issuing a bond at par

Date	Account	DR	CR
20YY.MM.DD	Cash	Price	
	Bond payable		Par value
<i>Issued a bond at par (price = par value)</i>			

P = \$100M, Price = \$100M, yield = 5%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2018.03.10	Cash	100M	
	Bond payable		100M
<i>Issued a bond at par (price = par value)</i>			

# Bonds at par: Coupon payment

- Step 2: Account for coupon payments
  - Interest expense
  - Cash payment is the coupon

## Example: Paying a bond coupon

Date	Account	DR	CR
20YY.MM.DD	Interest expense	CF	
	Cash		CF
<i>Paid coupon on bond</i>			

P = \$100M, Price = \$100M, yield = 5%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2018.09.10	Interest expense	2.5M	
	Cash		2.5M
<i>Paid coupon on bond (<math>P * i / n = \\$100M * 5\% / 2 = \\$2.5M</math>)</i>			

# Bonds at par: Adjusting entry

- Step 3: Account for accrued interest expense at year end
  - The accrued interest is based on the number of *days*
    - We'll use 30/360 day counts unless otherwise stated
    - Interest owed will be  $CF \times \frac{days}{180}$

## Example: Adjusting entry, accruing interest expense

Date	Account	DR	CR
20YY.MM.DD	Interest expense	CF*days/180	
	Interest payable		CF*days/180
<i>Accrued interest expense on bond</i>			

P = \$100M, Price = \$100M, yield = 5%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2018.12.31	Interest expense	1.54M	
	Interest payable		1.54M
<i>Accrued int exp on bond, Full coupon=\$2.5M; Days=111; 2.5M*111/180 = 1.54M</i>			

# Bonds at par: Coupon after adjusting

- Step 2 revisited: Account for coupon payments

## Example: Paying a bond coupon after an adjusting entry

Date	Account	DR	CR
20YY.MM.DD	Interest expense	CF - payable	
	Interest payable	payable	
	Cash		CF

*Paid coupon on bond, with some amount of interest expense previously accrued*

P = \$100M, Price = \$100M, yield = 5%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2019.03.10	Interest expense	0.96M	
	Interest payable	1.54M	
	Cash		2.5M

*Paid coupon on bond, with some amount of interest expense previously accrued.  
Full Interest Expense = 2.5M. Partial int exp = 2.5M - 1.54M = 0.96M.*

# Bonds at par: Final payment

- Step 4: In the final period, pay back the principal (and a coupon)
- Since interest expense is the same every period for bonds at par, we can figure this out

## Example: Paying a bond coupon and principal after an adjusting entry

Date	Account	DR	CR
20YY.MM.DD	Interest expense	CF-payable	
	Interest payable	payable	
	Bond payable	P	
	Cash		CF + P

*Paid principal and paid coupon on bond (some interest expense previously accrued)*

P = \$100M, Price = \$100M, yield = 5%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2028.03.10	Interest expense	0.96M	
	Interest payable	1.54M	
	Bond payable	100M	
	Cash		102.5M

*Paid principal and paid coupon on bond (some interest expense previously accrued)*

# Practice: Bonds at par

- Bond: Ford's **F.GD**
  - Principal: \$366.53M
  - Yield: 9.3%
  - Coupon rate: 9.3%
  - Semiannual coupons
  - 30/360
  - Issued on March 1, 1998
  - 32 year bond
  - Note: Ford's fiscal year ends on December 31

Determine Ford's journal entries for the bond for issuance, the first coupon, the adjusting entry, and the second coupon



# Accounting for bonds: Discount

# Discount bonds

- Trading at a price *below* par!
  - Equivalent to having a coupon rate *lower than* yield
- Example bond for these slides:
  - Principal = \$100M
  - *Price = \$92.56M*
  - *Yield = 6%*
  - Coupon rate = 5%
  - Semiannual coupon payments (every 6 months)
  - Count basis: 30/360
- Assume it's a 10 year bond issued on March 10th, 2018
- Assume the firm issuing the bond uses a Dec 31 year end

# Effective interest method

- Recall:
  - Bond payable amount is the par value
  - Cash amount is the price
- Since these aren't equal, our very first entry won't balance!

We'll use the *Effective Interest Method* to fix this

- Record a *contra-liability* to our bond payable to reflect the difference
  - Account name is *Discount on bonds payable*
- Over time, we remove the discount by recording extra interest expense each period
- Define *Carrying value* to be *Payable – Discount*

Interest expense will be  $Carrying\ value \times yield/n$

# Calculations for discount bonds

## Interest and carrying values

Period	IntExp_Calc	Interest_Expense	Coupon	Carry_Calc	Carrying_Value
0					92.56M
1	$92.56M \times 6\% / 2 =$	2.78M	2.5M	$92.56M + 2.78M - 2.5M =$	92.84M
2	$92.84M \times 6\% / 2 =$	2.79M	2.5M	$92.84M + 2.79M - 2.5M =$	93.12M
3	$93.12M \times 6\% / 2 =$	2.79M	2.5M	$93.12M + 2.79M - 2.5M =$	93.42M
4	$93.42M \times 6\% / 2 =$	2.80M	2.5M	$93.42M + 2.80M - 2.5M =$	93.72M
...	...	...	...	...	...

## Initial price

- $P = \$100M$
- $CF = \$100M \times 5\% / 2 \text{ per year} = \$2.5M$
- $T = 10 \text{ years} \times 2 \text{ per year} = 20 \text{ half-years}$
- $r = 6\% / 2 \text{ per year} = 3\%$

$$\begin{aligned} \text{Price} &= \frac{CF}{r} \cdot \left[ 1 - \frac{1}{(1+r)^T} \right] + \frac{P}{(1+r)^T} \\ &= \frac{\$2.5M}{0.03} \cdot \left[ 1 - \frac{1}{(1+0.03)^{20}} \right] + \frac{\$100M}{(1+0.03)^{20}} \\ &\approx \$92.56M \end{aligned}$$

# Bonds at discount: Issuance

- Step 1: Account for bond issuance

## Example: Issuing a bond at discount

Date	Account	DR	CR
20YY.MM.DD	Cash	Price	
	Discount on bond payable	Discount	
	Bond payable		Par value
<i>Issued a bond at par (price &lt; par value)</i>			

P = \$100M, Price = \$92.56M, yield = 6%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2018.03.10	Cash	92.56M	
	Discount on bond payable	7.44M	
	Bond payable		100M
<i>Issued a bond at par (price &lt; par value)</i>			

# Bonds at discount: Coupon payment

- Step 2: Account for coupon payments
  - Need to use the effective interest method!

## Example: Paying a bond coupon for a discount bond

Date	Account	DR	CR
20YY.MM.DD	Interest expense	Carry*yield/n	
	Discount on bond payable		Int exp - CF
	Cash		CF

*Paid coupon on bond, amortized part of discount*

P = \$100M, Price = \$92.56M, yield = 6%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2018.09.10	Interest expense	2.78M	
	Discount on bond payable		0.28M
	Cash		2.5M

*Paid coupon on bond, amortized part of discount. Int exp = 92.56M \* 6%/2 = 2.78M*

# Bonds at discount: Adjusting entry

- Step 3: Account for accrued interest expense at year end
  - Interest owed and interest expense will be multiplied by  $\frac{\text{days}}{180}$

## Example: Adjusting entry, accruing interest expense, discount bond

Date	Account	DR	CR
20YY.MM.DD	Interest expense	Carry*yield/n * days/180	
	Discount on bond payable		IE - IP
	Interest payable		CF*days/180
<i>Accrued interest expense on bond</i>			

P = \$100M, Price = \$92.56M, yield = 6%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2018.12.31	Interest expense	1.72M	
	Discount on bond payable		0.18M
	Interest payable		1.54M
<i>Accrued interest expense on bond, Days=111. Carry = 92.56 + 0.28 = 92.84. Full Interest Expense = 92.84M*6%/2 = 2.79M. Partial int exp = 2.79M*111/180 = 1.72M</i>			

# Bonds at discount: Coupon after adjusting

- Step 2 revisited: Account for coupon payments

## Example: Paying a bond coupon after an adjusting entry, discount bond

Date	Account	DR	CR
20YY.MM.DD	Interest expense	Carry*yield/n * days/180	
	Interest payable	payable	
	Discount on bond payable		IE + IP - CF
	Cash		CF

*Paid coupon on bond, with some amount of interest expense previously accrued*

P = \$100M, Price = \$92.56M, yield = 6%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2019.03.10	Interest expense	1.07M	
	Interest payable	1.54M	
	Discount on bond payable		0.11M
	Cash		2.5M

*Paid coupon on bond, with some amount of interest expense previously accrued.  
Full Interest Expense =  $92.84M * 6\% / 2 = 2.79M$ . Partial int exp =  $2.79M - 1.72M = 1.07M$ .*

# Bonds at discount: Final payment

- Step 4: In the final period, pay back the principal (and a coupon)
- You won't be asked to figure this out without extra information

## Example: Paying a coupon and principal after an adjusting entry, discount bond

Date	Account	DR	CR
20YY.MM.DD	Interest expense	Carry*yield/n * days/180	
	Interest payable	payable	
	Bond payable	P	
	Discount on bond payable		IE + IP - CF
	Cash		CF + P

*Paid principal and paid coupon on bond (some interest expense previously accrued)*

P = \$100M, Price = \$92.56M, yield = 6%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2028.03.10	Interest expense	1.14M	
	Interest payable	1.54M	
	Bond payable	100M	
	Discount on bond payable		0.18M
	Cash		102.5M

*Paid principal and paid coupon on bond (some interest expense previously accrued)*

# Accounting for bonds: Premium

# Premium bonds

- Trading at a price *above* par!
  - Equivalent to having a coupon rate *higher than* yield
- Example bond for these slides:
  - Principal = \$100M
  - *Price = \$108.18M*
  - *Yield = 4%*
  - Coupon rate = 5%
  - Semiannual coupon payments (every 6 months)
  - Count basis: 30/360
- Assume it's a 10 year bond issued on March 10th, 2018
- Assume the firm issuing the bond uses a Dec 31 year end

# Effective interest method

- Recall:
  - Bond payable amount is the par value
  - Cash amount is the price
- Since these aren't equal, our very first entry won't balance!

We'll use the *Effective Interest Method* to fix this

- Record a *liability* along with our bond payable to reflect the difference
  - Account name is *Premium on bonds payable*
- Over time, we remove the premium by recording lower interest expense each period
- Define *Carrying value* to be  $Payable + Premium$

Interest expense will be  $Carrying\ value \times yield/n$

# Calculations for premium bonds

## Interest and carrying values

Period	IntExp_Calc	Interest_Expense	Coupon	Carry_Calc	Carrying_Value
0					108.18M
1	$108.18M \times 4\% / 2 =$	2.16M	2.5M	$108.18M + 2.16M - 2.5M =$	107.84M
2	$107.84M \times 4\% / 2 =$	2.16M	2.5M	$107.84M + 2.16M - 2.5M =$	107.50M
3	$107.50M \times 4\% / 2 =$	2.15M	2.5M	$107.50M + 2.15M - 2.5M =$	107.15M
4	$107.15M \times 4\% / 2 =$	2.14M	2.5M	$107.15M + 2.14M - 2.5M =$	106.79M
...	...	...	...	...	...

## Initial price

- $P = \$100M$
- $CF = \$100M \times 5\% / 2 \text{ per year} = \$2.5M$
- $T = 10 \text{ years} \times 2 \text{ per year} = 20 \text{ half-years}$
- $r = 4\% / 2 \text{ per year} = 2\%$

$$\begin{aligned} \text{Price} &= \frac{CF}{r} \cdot \left[ 1 - \frac{1}{(1+r)^T} \right] + \frac{P}{(1+r)^T} \\ &= \frac{\$2.5M}{0.02} \cdot \left[ 1 - \frac{1}{(1+0.02)^{20}} \right] + \frac{\$100M}{(1+0.02)^{20}} \\ &\approx \$108.18M \end{aligned}$$

# Bonds at premium: Issuance

- Step 1: Account for bond issuance

## Example: Issuing a bond at premium

Date	Account	DR	CR
20YY.MM.DD	Cash	Price	
	Premium on bond payable		Premium
	Bond payable		Par value
<i>Issued a bond at par (price &gt; par value)</i>			

P = \$100M, Price = \$108.18M, yield = 4%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2018.03.10	Cash	108.18M	
	Premium on bond payable		8.18M
	Bond payable		100M
<i>Issued a bond at par (price &gt; par value)</i>			

# Bonds at premium: Coupon payment

- Step 2: Account for coupon payments
  - Need to use the effective interest method!

## Example: Paying a bond coupon for a premium bond

Date	Account	DR	CR
20YY.MM.DD	Interest expense	Carry*yield/n	
	Premium on bond payable	CF - int exp	
	Cash		CF

*Paid coupon on bond, amortized part of discount*

P = \$100M, Price = \$108.18M, yield = 4%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2018.09.10	Interest expense	2.16M	
	Premium on bond payable	0.34M	
	Cash		2.5M

*Paid coupon on bond, amortized part of discount. Int exp = 108.18.M \* 4%/2 = 2.16M*

# Bonds at premium: Adjusting entry

- Step 3: Account for accrued interest expense at year end
  - Interest owed and interest expense will be multiplied by  $\frac{\text{days}}{180}$

## Example: Adjusting entry, accruing interest expense, premium bond

Date	Account	DR	CR
20YY.MM.DD	Interest expense	Carry*yield/n * days/180	
	Premium on bond payable	IP - IE	
	Interest payable		CF*days/180
<i>Accrued interest expense on bond</i>			

P = \$100M, Price = \$108.18M, yield = 4%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2018.12.31	Interest expense	1.33M	
	Premium on bond payable	0.21M	
	Interest payable		1.54M
<i>Accrued interest expense on bond, Days=91. Carry = 108.18 - 0.34 = 107.84. Full Interest Expense = 107.84M*4%/2 = 2.16M. Partial int exp = 2.16M*111/180 = 1.33M</i>			

# Bonds at premium: Coupon after adjusting

- Step 2 revisited: Account for coupon payments

## Example: Paying a bond coupon after an adjusting entry, premium bond

Date	Account	DR	CR
20YY.MM.DD	Interest expense	Carry*yield/n * days/180	
	Interest payable	payable	
	Premium on bond payable	CF - IP - IE	
	Cash		CF

*Paid coupon on bond, with some amount of interest expense previously accrued*

P = \$100M, Price = \$108.18M, yield = 4%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2019.03.10	Interest expense	0.83M	
	Interest payable	1.54M	
	Premium on bond payable	0.13M	
	Cash		2.5M

*Paid coupon on bond, with some amount of interest expense previously accrue.  
Full Interest Expense =  $107.84M * 4\% / 2 = 2.16M$ . Partial int exp =  $2.16M - 1.33M = 0.83M$*

# Bonds at premium: Final payment

- Step 4: In the final period, pay back the principal (and a coupon)
- You won't be asked to figure this out without extra information

## Example: Paying a coupon and principal after an adjusting entry, premium bond

Date	Account	DR	CR
20YY.MM.DD	Interest expense	Carry*yield/n * days/180	
	Interest payable	payable	
	Bond payable	P	
	Premium on bond payable	CF - IP - IE	
	Cash		CF + P

*Paid principal and paid coupon on bond (some interest expense previously accrued)*

P = \$100M, Price = \$108.18M, yield = 4%, Coupon rate = 5%, semiannual, 30/360 count



Date	Account	DR	CR
2028.03.10	Interest expense	0.77M	
	Interest payable	1.54M	
	Bond payable	100M	
	Premium on bond payable	0.19M	
	Cash		102.5M

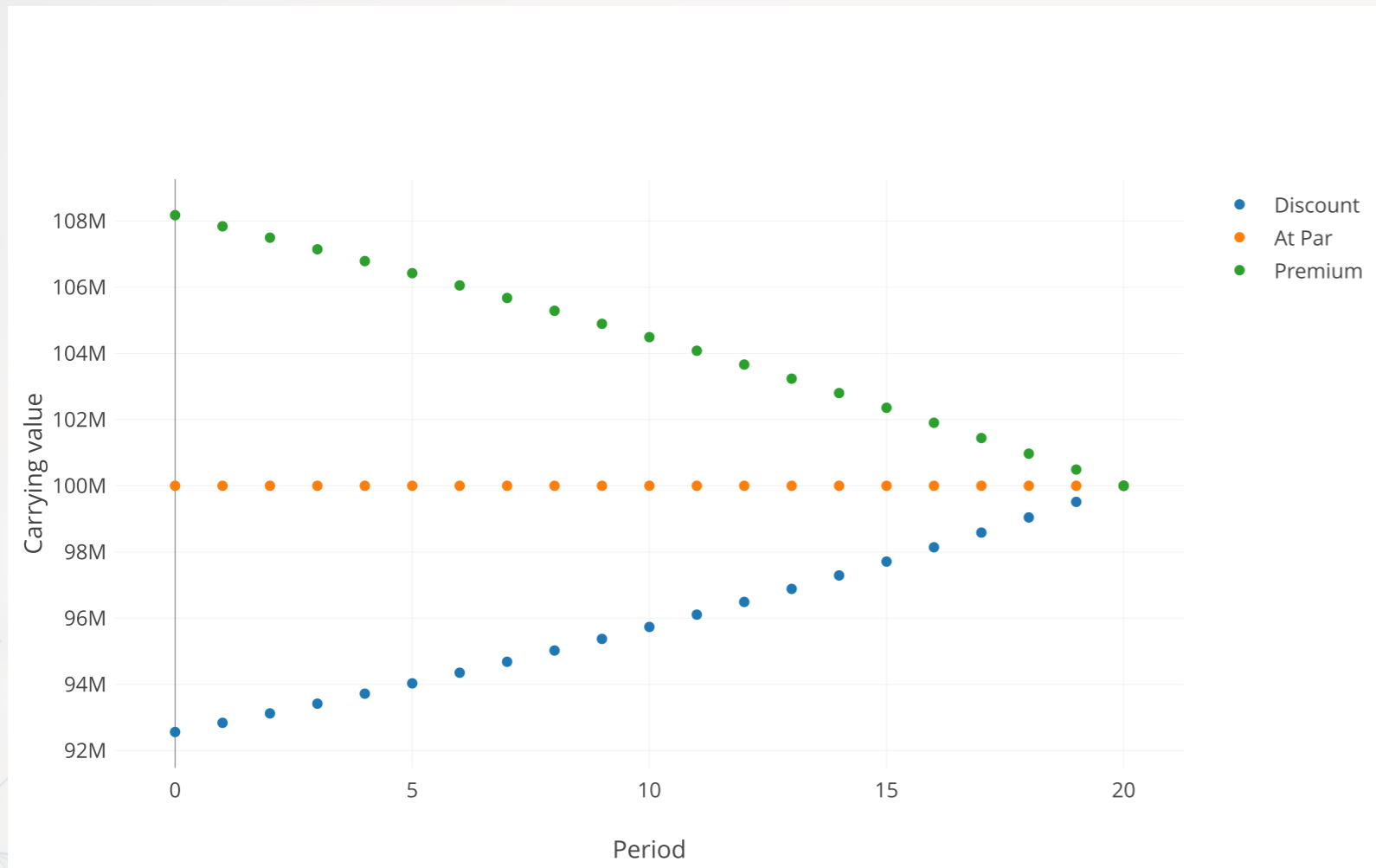
*Paid principal and paid coupon on bond (some interest expense previously accrued)*

**Bonds not at par**

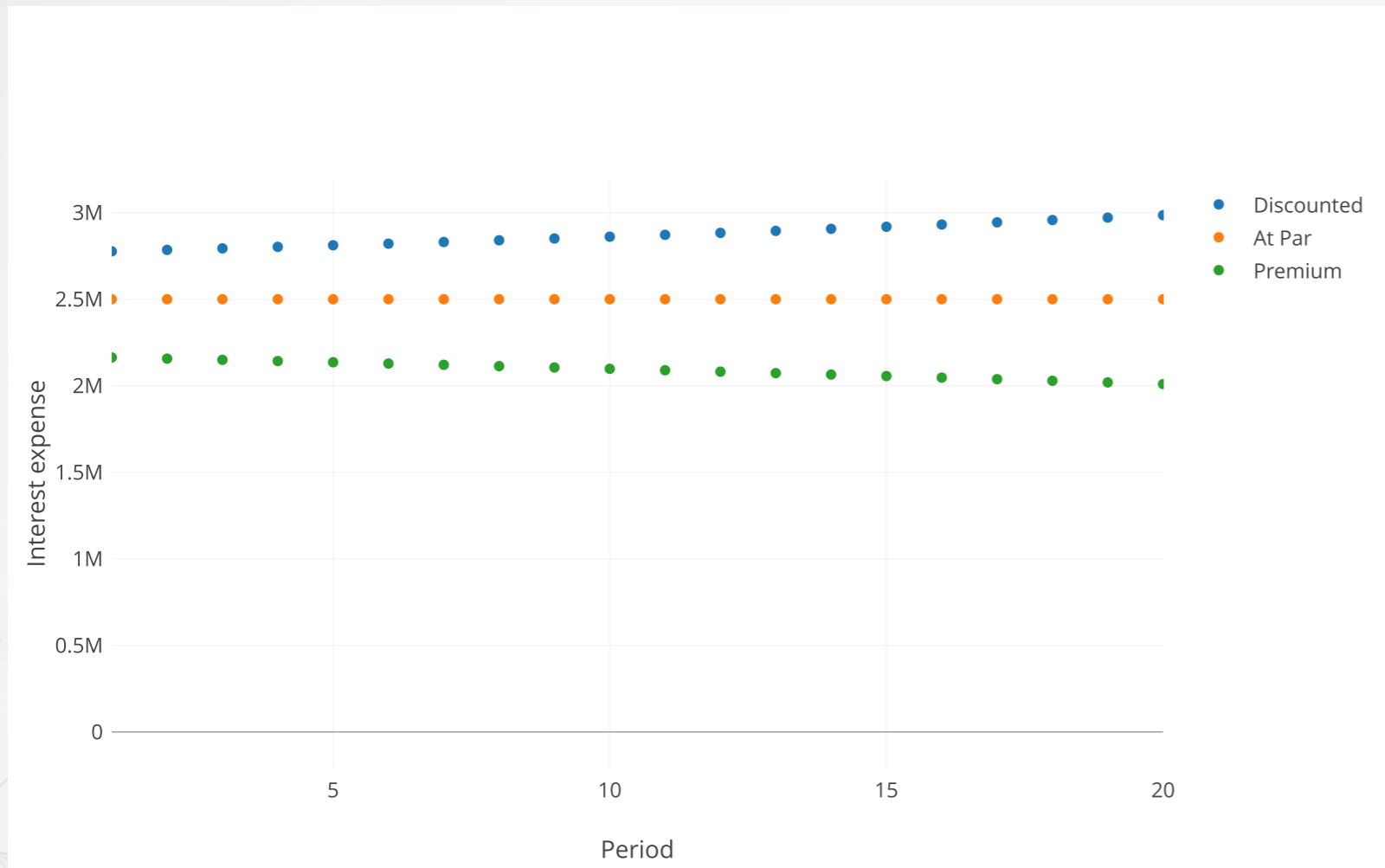
# What's actually going on here?

- The effective interest method distributes the discount or premium over the life of the bond
  - The discount or premium hits 0 just as the last coupon is paid
- Discounts lead to higher expenses each year
  - We treat the shortfall in cash for a discount bond as a large amount of interest expense, and amortize it over the life of the bond
- Premiums lead to lower expenses each year
  - We treat the excess cash for a premium bond as free money that will cancel out some of our interest payments, and thus we amortize it over the life of the bond

# Visualizing Carrying value



# Interest Expense



# Practice: Bonds not at par

For each of the following bonds, calculate the price and determine Ford's journal entries for the bond for issuance, and the next 3 journal entries (1 adjusting and 2 coupon payments). Ford's fiscal year end is December 31st.

- Bond: Ford's **F.GY** (Discount)

- Principal: \$1,800M
- Yield: 7.53%
- Coupon rate: 7.45%
- Semiannual coupons
- 30/360
- Issued on July 16, 1999
- 32 year bond

- Bond: Ford's **F.GI** (Premium)

- Principal: \$300M
- Yield: 9.04%
- Coupon rate: 9.950%
- Semiannual coupons
- 30/360
- Issued on February 15, 1992
- 40 year bond





# Bond retirement

# Bond retirement

- Firms can retire a bond in two ways:
  1. Work with creditors to establish a price to pay to end the bond.
  2. Buy back bonds on the market.
- To retire a bond:
  1. Record any accrued interest expense
  2. Debit out the bond payable account and any interest payable
  3. Close out any premium or discount account
  4. Credit the amount of cash paid to retire the bond
  5. Record the difference to a *gain on bond retirement* if credit balance, or to a *loss on bond retirement* if debit balance

# Bond retirement example: Bond at par

Suppose our example bond at par was retired after 1.25 years, on 2019.06.10, for par plus accrued interest.

- Par: \$100M, Coupon rate: 5%, Yield: 5%
- Carrying value on 2019.03.10: \$100M
- Accrued interest (to pay):  $\$100M \times \frac{5\%}{2} \times \frac{90}{180} = \$1.25M$
- Accrued interest expense:  $\$100M \times \frac{5\%}{2} \times \frac{90}{180} = \$1.25M$

**Example: Bond retirement, bond at par**

Date	Account	DR	CR
2019.06.10	Bond payable	100M	
	Interest expense	1.25M	
	Cash		101.25M

*Retired bond at par for par plus accrued interest*

# Bond retirement example: Discount bond

Suppose our example discount bond was retired after 1.25 years, on 2019.06.10, for par plus accrued interest.

- Par: \$100M, Coupon rate: 5%, Yield: 6%
- Carrying value on 2019.03.10: \$93.12M (discount: \$6.88M)
- Accrued interest (to pay):  $\$100M \times \frac{5\%}{2} \times \frac{90}{180} = \$1.25M$
- Accrued interest expense:  $\$93.12M \times \frac{6\%}{2} \times \frac{90}{180} = \$1.40M$

**Example: Bond retirement, discount bond**

Date	Account	DR	CR
2019.06.10	Bond payable	100M	
	Interest expense	1.40M	
	Loss on bond retirement	6.73M	
	Discount on bond payable		6.88M
	Cash		101.25M

*Retired discount bond at par plus accrued interest at a loss*

# Bond retirement example: Premium bond

Suppose our example premium bond was retired after 1.25 years, on 2019.06.10, for par plus accrued interest.

- Par: \$100M, Coupon rate: 5%, Yield: 4%
- Carrying value on 2019.03.10: \$107.50M (premium: \$7.50M)
- Accrued interest (to pay):  $\$100M \times \frac{5\%}{2} \times \frac{90}{180} = \$1.25M$
- Accrued interest expense:  $\$107.50M \times \frac{4\%}{2} \times \frac{90}{180} = \$1.07M$

**Example: Bond retirement, premium bond**

Date	Account	DR	CR
2019.06.10	Bond payable	100M	
	Interest expense	1.07M	
	Premium on bond payable	7.50M	
	Gain on bond retirement		7.32M
	Cash		101.25M

*Retired premium bond at par plus accrued interest at a gain*

**End matter**

# Wrap up

- For next week
  1. **Quiz 2** – many extra practices on eLearn
  2. Recap the reading for this week
  3. Read the pages for next week
    - Financial statement analysis (Chapter 12)
  4. Homework to *turn in early next week*
    - Available on eLearn
    - Submit on eLearn
    - Graded based on effort!
  5. Practice on eLearn
    - Practice on Bonds
    - Automatic feedback provided
- Survey on the class session at [rmc.link/101survey8](https://rmc.link/101survey8)



# Packages used for these slides

- kableExtra

- knitr

- revealjs

