

PRINCIPLES OF ACCOUNTING II
ACC 122

BOND DISCOUNTS/PREMIUMS

SELLING BONDS AT A DISCOUNT

The contract rate is the stated interest rate on the bond, the market rate is the consensus rate that borrowers are willing to pay and that lenders are willing to earn at the level of risk inherent in the bond.

CONTRACT RATE < MARKET RATE

Bonds sell at a discount (below face value).

EXAMPLE: (Same facts on Bond Handout)

1. Sold bonds with a face value of \$100,000 for \$92,000 on 1/1/X1 because the market rate of interest is 12%:

Cash	92,000	
Discount on Bonds Payable	8,000	
Bonds Payable		100,000

2. When the semiannual cash payment is made, the following entry is recorded:

Interest Expense	5,800	
Discount on Bonds Payable		800
Cash		5,000

Calculation:

Discount = \$8,000
Life of Bond = 5 years
Straight-line Amortization $\$8,000/5 = \$1,600/\text{year}$ or $\$800/\text{semiannual}$

When bonds reach maturity date, the Discount on Bonds Payable account should have a zero balance. This will occur because the discount increases interest expense and is amortized to Interest Expense over the outstanding life of the bond.

SELLING BONDS AT A PREMIUM

CONTRACT RATE > MARKET RATE

Bonds sell at a premium (above face value).

EXAMPLE: (Same facts on Bond Handout)

1. Sold bonds with a face value of \$100,000 for \$106,000 on 1/1/X1 because the market rate of interest is 8%:

Cash	106,000	
Premium on Bonds Payable		6,000
Bonds Payable		100,000

2. When the semiannual cash payment is made, the following entry is recorded:

Interest Expense	4,400	
Premium on Bonds Payable	600	
Cash		5,000

Calculation:

Premium = \$6,000
Life of Bond = 5 years
Straight-Line Amortization $\$6,000/5 = \$1,200/\text{year}$ or $\$600/\text{semiannual}$

When bonds reach maturity date, the Premium on Bonds Payable account should have a zero balance. This will occur because the premium decreases interest expense and is amortized to Interest Expense over the outstanding life of the bond.