

ADMS 2500 - Introduction to Financial Accounting

Bonds Payable

1. What are Bonds?
2. Accounting for Discount Bonds
3. Accounting for Premium Bonds
4. Practice past midterm problems

What are Bonds?

- When a firm issues a bond it is essentially raising money from the public today in exchange for making promised repayments of principal (face value or par value) and interest (coupons). Therefore, bonds are a form of long term debt financing for the firm.

Types of Bonds

- **Debenture Bond** – Are unsecured bonds with no collateral placed by the firm
- **Retractable Bond** – Can be retired at the option of the bond holder, i.e. the investor can redeem the bond for cash
- **Convertible Bond** – Can be exchanged for another security issued by the firm like common shares, at the option of the investor
- **Callable Bond** – Is a bond that can be retired early by the firm, i.e. it can be called back by the issuer

Cash Flows Generated by a Bond

- When the firm issues a bond, it receives an amount of cash today equal to the **issue price** of the bonds. In exchange the firm promises to repay the principal amount known as the **face value or par value** of the bond and to make periodic payments of interest known as the **coupons**.
- What is important to realize is that when a firm sells a bond to the public it can receive either more or less money today than the principal amount that will need to be repaid in the future. In other words the price that the bond is issued for is not going to necessarily be the same as the par value of the bond.
- The reason why the price of the bond may be different than the par value is because of differences in the coupon rate and the market rate of interest. It is important for us to understand the difference between these two rates since they will be given in every bond question:

Example: Discount Bond

On January 1 ABC Inc. issued \$10,000 of face value bonds when the market rate of interest was 12% and the stated rate of interest was 10%. The bonds have 10 years remaining to maturity and make semi-annual payments of interest on June 30 and Dec 31.

Example: Premium Bond

On January 1 ABC Inc. issued \$10,000 of face value bonds when the market rate of interest was 8% and the stated rate of interest was 10%. The bonds have 10 years remaining to maturity and make semi-annual payments of interest on June 30 and Dec 31.

Coupon Rate vs Market Rate

Case	Bond Type	Price	Why?
Contractual Rate < Market Rate	Discount Bond	Issue Price < Face Value	To compensate investor for the below market interest rate that they are
Contractual Rate = Market Rate	Par-Value Bond	Issue Price = Face Value	Fairly Priced
Contractual Rate > Market Rate	Premium Bond	Issue Price > Face Value	To compensate firm for offering above market coupons to investor