Financial & Managerial Accounting
Study Guide

Miami Dade Community College

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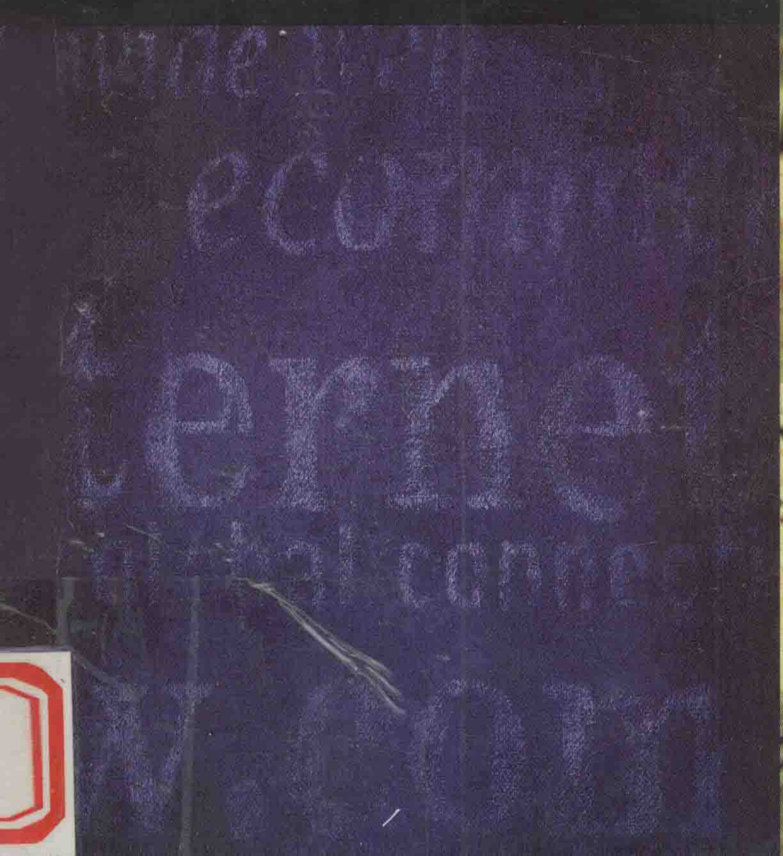

Financial & Managerial Accounting Study Guide

Miami Dade Community College

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F13

Bonds Payable and Investments in Bonds

QUIZ AND TEST HINTS

The following hints may be helpful to you in preparing for a quiz or a test over the material covered in Chapter F13.

1. Study the new terminology introduced in this chapter for possible use in fill-in-the-blank, multiple-choice, or true/false questions. As a review of the key terms, do the Matching Exercise on pages F534–F535.
2. It is unlikely that you will see a problem related to the Financing Corporations section of the chapter. Instead, you should focus primarily on being able to prepare the various journal entries illustrated throughout the chapter. The Illustrative Problem is a good study aid for reviewing the various journal entries.
3. If your instructor discussed the computation of present value of bonds payable, you should expect one or more questions on this topic.
4. Be ready to prepare entries for the issuance of bonds at face value, at a discount, and at a premium; for discount and premium amortization; and for bond redemption.
5. Be able to prepare journal entries for bond investments. You will more likely see a question requiring journal entries for the issuance of bonds payable, but occasionally instructors will include short problems on bond investments. You can assess the likelihood of such a problem by the amount of time your instructor spent lecturing on bond investments and whether you were assigned a homework problem on bond investments.

FILL IN THE BLANK—Part A

Instructions: Answer the following questions or complete the statements by writing the appropriate words or amounts in the answer blanks.

1. A corporation issuing bonds enters into a contract with the bondholders. This contract is known as a(n) ____________ ____________________.
2. A corporation reserves the right to redeem _________________ bonds before they mature.
3. Bonds issued on the general credit of the issuing corporation are called ____________________ ____________.
4. The ________________ rate determines the periodic interest paid on a bond.
5. When the market rate of interest on bonds is lower than the contract rate, the bonds will sell at a(n) ________________.
6. Assuming an interest rate of 10%, $110 to be received a year from today is called the _______________ ______________ of $100 today.
7. The present value of $1,000 to be paid one year later, using an interest rate of 10% is ______________.
8. If the market rate of interest is 11%, the present value of $10,000 to be received in each of the next 2 years is ______________ (round to the nearest dollar).

9–10. The two methods for amortizing a bond discount are the ____________-_________ method and the ________________ ________________ _________ method.

11. The amount set aside for the payment of bonds at maturity is called a(n) _______________ __________.
12. The balance of the bonds payable account (face amount of the bonds) less any unamortized discount or plus any unamortized premium is called the ________________ _______________.
13. If the balances of Bonds Payable and Discount on Bonds Payable are $400,000 and $12,000, respectively, the carrying amount of the bonds is ______________.
14. If $2,000,000 of bonds are sold at 101½, the amount of cash received is ______________.
15. Bonds with a face amount of $100,000 were purchased through a broker at 103 plus accrued interest of $2,000 and brokerage commissions of $650. The amount to be debited to the investment account is ______________.

Name: ______________________________

16–17. A corporation purchased bonds at a premium several years ago. When this year ends, the company makes an entry to record the amortization of the premium.

16. The account to be debited is ______________ ______________.

17. The account to be credited is ____________________ ___ __________.

18. Jones Company has redeemed bonds at 102. The bonds have a face value of $600,000 and an unamortized premium of $10,000. Jones Company will record a gain (or loss) on redemption of __________________ (indicate amount and gain or loss).

19. Smith Company intends to hold 10-year bonds until they mature. This asset is called a ________-____-______________ ______________.

20. River Company had interest expenses of $2,500,000 and income before tax of $29,000,000. The number of times interest charges are earned is ______________.

FILL IN THE BLANK—Part B

Instructions: Answer the following questions or complete the statements by writing the appropriate words or amounts in the answer blanks.

1. All of Sand Company's bonds mature at the same time. These are known as __________ bonds.
2. Bonds that may be exchanged for other securities are called ____________________ bonds.
3. When the contract rate of interest on bonds is lower than the market rate of interest, the bonds sell at a(n) _______________.
4. The present value of the face amount of a $1,000, 5-year bond, using an interest rate of 7% is _______________.
5. Oliver Company issues 10-year bonds with a face value of $100,000 and annual interest of 12%. The present value of the bonds' interest payments is _______________ (round to the nearest dollar).
6. A series of equal cash payments at fixed intervals is called a(n) _______________.
7. A firm redeemed bonds at 95. The bonds have a face value of $500,000 and an unamortized discount of $15,000. The firm will record a gain (or loss) on redemption of ______________________ (indicate amount and gain or loss).

8–11. Under which caption (current assets, investments, fixed assets, current liabilities, long-term liabilities, stockholders' equity) would each of the following appear on the balance sheet?

8. Investment in X Co. Bonds (management intends to hold to maturity in 5 years) would appear in the __________________ section of the balance sheet.
9. Premium on Bonds Payable would appear in the __________________ __________________ section of the balance sheet.
10. Bonds Payable due in ten years would appear in the ______________ __________________ section of the balance sheet.
11. Bond sinking fund investments would appear in the __________________ section of the balance sheet.
12. Bonds with a face value of $75,000 were purchased through a broker at 98 plus accrued interest of $1,000 and brokerage commissions of $350. The amount to be debited to the investment account is _______________.
13. If Bonds Payable has a balance of $5,000,000 and Premium on Bonds Payable has a balance of $45,000, the carrying amount of the bonds is _______________.

14–16. On April 1, Avery Company issued $4,000,000, 5-year, 12% bonds for $4,280,000. If the bonds pay interest semiannually and if the effective rate of interest is 10%, determine the following:

14. The interest paid on September 30 is ______________.

15. The amount of premium amortized on September 30, using the straight-line method is ______________.

16. The accrued interest payable on December 31 is ______________.

17. In No. 14, the total amount of annual interest expense ________________________ (increases, decreases, or remains the same) over the life of the bonds as the premium on bonds payable is amortized.

18. A ratio that indicates the likelihood a company will be able to continue paying interest to its debtholders if the company's earnings decrease is called the ______________ ______ ___________ ________________ ______________ ______________.

19. Canary Company had interest expenses of $8,250,000 and income before tax of $60,500,000. The number of times interest charges are earned is ______________.

20. The estimated worth today of an amount of cash to be received (or paid) in the future is called the ______________ __________.

MULTIPLE CHOICE

Instructions: Circle the best answer for each of the following questions.

1. A bond that gives the bondholder a right to exchange the bond for other securities under certain conditions is called a:
   - **a.** convertible bond
   - **b.** sinking fund bond
   - **c.** term bond
   - **d.** debenture bond
2. What is the present value of $2,000 to be paid in one year if the current interest rate is 6%?
   - **a.** $1,880
   - **b.** $1,887
   - **c.** $2,000
   - **d.** $2,120
3. The entry to record the amortization of a discount on bonds payable is:
   - **a.** debit Bonds Payable; credit Interest Expense
   - **b.** debit Interest Expense; credit Discount on Bonds Payable
   - **c.** debit Discount on Bonds Payable; credit Interest Expense
   - **d.** debit Discount on Bonds Payable; credit Bonds Payable
4. Under the straight-line method of bond discount amortization, as a bond payable approaches maturity, the total yearly amount of interest expense will:
   - **a.** increase
   - **b.** decrease
   - **c.** remain the same
   - **d.** increase or decrease, depending on the size of the original discount
5. On May 1, a $1,000 bond was purchased as a long-term investment at 104, and $8 was paid as the brokerage commission. If the bond bears interest at 6%, which is paid semiannually on January 1 and July 1, what is the total cost to be debited to the investment account?
   - **a.** $1,000
   - **b.** $1,040
   - **c.** $1,048
   - **d.** $1,068

Name:

6. What method of amortizing bond discount or premium is required by generally accepted accounting principles?
   a. declining balance method
   b. future value method
   c. principal method
   d. interest method
7. Bonds that do not provide for any interest payments are called:
   a. interest-free bonds
   b. held-to-maturity securities
   c. sinking-fund bonds
   d. zero-coupon bonds
8. The principal of each bond is also called the:
   a. present value
   b. future value
   c. face value
   d. contract value
9. A special fund accumulated over the life of a bond issue and kept separate from other assets in order to provide for payment of bonds at maturity is called a(n):
   a. sinking fund
   b. investment fund
   c. retirement fund
   d. redemption fund
10. Held-to-maturity securities are classified on the balance sheet as:
    a. current assets
    b. investments
    c. long-term liabilities
    d. sinking-fund assets

TRUE/FALSE

Instructions: Indicate whether each of the following statements is true or false by placing a check mark in the appropriate column.

	True	False
1. The interest rate specified on the bond indenture is called the contract rate or effective rate.	____	____
2. If the market rate is lower than the contract rate, the bonds will sell at a discount.	____	____
3. When zero-coupon bonds are issued, the discount is amortized as interest expense over the life of the bonds.	____	____
4. The straight-line method of allocating bond discount provides for a constant amount of interest expense each period.	____	____
5. Bonds that may be exchanged for other securities under certain conditions are called callable bonds.	____	____
6. When cash is transferred to the sinking fund, it is recorded in an account called Sinking Fund Investments.	____	____
7. A corporation's earnings per share can be affected by whether it finances its operations with common stock, preferred stock, or bonds.	____	____
8. If the price paid to redeem bonds is below the bond carrying value, the difference is recorded as a gain.	____	____
9. The balance in a discount on bonds payable account is reported in the balance sheet as a deduction from the related bonds payable.	____	____
10. The present value of a future amount becomes less as the interest rate used to compute the present value increases.	____	____

Name:

EXERCISE 13-1

(1) Star Corp. issued $500,000 of 10-year, 12% bonds on June 1 of the current year with interest payable on June 1 and December 1. Journalize the entries to record the following selected transactions for the current year:

June 1. Issued the bonds for cash at face amount.
Dec. 1. Paid the interest on the bonds.

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PAGE

	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT	
1							1
2							2
3							3
4							4
5							5
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(2) On April 1, Turner Inc. issued $1,000,000 of 10-year, 11% bonds, with interest payable semiannually on April 1 and October 1 at an effective interest rate of 12%, receiving cash of $942,645. Journalize the entries to record the following selected transactions for the current year:

Apr. 1. Sold the bonds.
Oct. 1. Made first interest payment and amortized discount for six months using the straight-line method.

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	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT	
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11							11

(3) On March 1, Sullivan Inc. issued $700,000 of 10-year, 11% bonds at an effective interest rate of 10%. Interest is payable semiannually on March 1 and September 1. Journalize the entries to record the following selected transactions for the current year. (Hint: To complete this portion of the exercise, you must compute the present value of the bonds at the issue date.)

Mar. 1. Sold the bonds.

Sept. 1. Made first interest payment and amortized premium for six months using the straight-line method.

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DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT

EXERCISE 13-2

Grimes Co. issued $5,000,000 of 10-year bonds at face value on January 1 of the current year.

Instructions:

(1) Assume the bonds are called at 101. Prepare the entry to record the redemption of the bonds.

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DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT

Name:

(2) Assume the bonds are purchased on the open market at 98. Prepare the entry to record the redemption of the bonds.

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	DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT	
1						1
2						2
3						3
4						4
5						5

EXERCISE 13-3

Record the following transactions. (Omit explanations.)

(1) On October 1, 20XA, purchased for cash, as a long-term investment, \$400,000 of Elgin Inc. 10% bonds at 99 plus accrued interest of \$10,000.

(2) On December 31, 20XA received first semiannual interest.

(3) On December 31, 20XA amortized \$120 discount on the bond investment.

(4) On December 1, 20XC, sold the bonds at 102 plus accrued interest of \$16,667. The carrying amount of the bonds was \$397,040 at the time of sale.

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15						15
16						16

PROBLEM 13-1

Jackson Inc. issued $2,000,000 of 10-year, 11% bonds with interest payable semiannually.

Instructions:

(1) Compute (a) the cash proceeds and (b) the amount of premium or discount from the sale of the bonds if the effective interest rate is 11%.

(2) Compute (a) the cash proceeds and (b) the amount of premium or discount from the sale of the bonds if the effective interest rate is 12%.

(3) Compute (a) the cash proceeds and (b) the amount of premium or discount from the sale of the bonds if the effective interest rate is 10%.

Name:

PROBLEM 13-2

On December 31 of the current fiscal year, Palus Inc. issued $500,000 of 10-year, 11% bonds. The bonds were dated December 31 of the same year. Interest on the bonds is payable on June 30 and December 31 of each year.

Instructions:

Record the following transactions. (Omit explanations and round to the nearest dollar.)

(1) The bonds were sold for $531,161 on December 31 of the current year. The market rate of interest on this date was 10%.

(2) Interest was paid on June 30, and the related amount of bond premium was amortized, based on the straight-line method.

(3) Interest was paid on December 31, and the related amount of bond premium was amortized, based on the straight-line method.

(4) On December 31 (bonds are one year old), one-half of the bonds were redeemed at 103.

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	DATE		DESCRIPTION	POST. REF.	DEBIT	CREDIT	
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PROBLEM 13-3

On January 1 of the current fiscal year, Block Co. issued $1,000,000 of 10-year, 10% bonds. The bonds were dated January 1 of the same year. Interest on the bonds is payable on June 30 and December 31 of each year.

Instructions:

Record the following transactions. (Omit explanations and round to the nearest dollar.)

(1) The bonds were sold for $885,295 on January 1 of the current year. The market rate of interest on that date was 12%.

(2) Interest was paid on June 30, and the related amount of bond discount was amortized, based on the straight-line method.

(3) Interest was paid on December 31, and the related amount of bond discount was amortized, based on the straight-line method.

(4) On December 31 (bonds are one year old), one-half of the bonds were redeemed at 98.

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DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT