10. Bonds Issued Between Interest Dates and Bond Retirement

This issue is best understood in the context of a specific example. Suppose Thompson Corporation proposed to issue $100,000 of 12% bonds, dated April 1, 20X1. However, despite the April 1 date, the actual issuance was slightly delayed, and the bonds were not sold until June 1. Nevertheless, the covenant pertaining to the bonds specifies that the first 6-month interest payment date will occur on September 30 in the amount of $6,000 ($100,000 X 12% X 6/12). In effect, interest for April and May has already accrued ($100,000 X 12% X 2/12 = $2,000) at the time the bonds are actually issued. To be fair, Thompson will collect $2,000 from the purchasers of the bonds at the time of issue, and then return it within the $6,000 payment on September 30 -- effectively causing the net difference of $4,000 to represent interest expense for June, July, August, and September ($100,000 X 12% X 4/12). The resulting journal entries are:

6-1-X1	Cash		102,000	
	Interest Payable			2,000
	Bonds Payable			100,000
	To record issuance of 100, 12% bonds			
9-30-X1	Interest Expense		4,000	
	Interest Payable		2,000	
	Cash			6,000
	To record interest payment (includes return of accrued interest payable from original issue on June 1)			

You should also be aware that the concepts just revealed for bonds issued between interest payment dates are also applicable to bonds that are traded between investors. There is no requirement, indeed no expectation, that bond investors will continue to hold bonds to maturity. Bonds are financial instruments that are traded between investors, just like stocks. When bond investors sell bonds between interest dates, they will receive from the purchaser the price plus accrued interest, knowing that the purchaser will then receive a full period's interest on the next regularly scheduled interest date. This mechanism is intended to simplify the bond issuer's accounting by allowing one interest payment to the current holder, rather than having to provide pro-rata payments to the various investors who have held the bonds for a portion of each interest period.

Someday you will likely consider investing in bonds, and this information about the handling of accrued interest between interest dates will come in useful to you. And, you also need to be keenly aware that your bond investments can change in value. Remember that the value of a bond is a function of the bond's stated rate of interest in relation to the going market rate of interest. If market interest rates rise while you hold your bond investment, look for its market value to decline (reflecting a lower present value based on the higher discount rate) -- and vice versa. Of course, if

you hold on to the bond to maturity, its value will converge to the face value (so long as the issuer does not go broke)!

10.1 Year-end Interest Accruals

Continuing the illustration for Thompson, what December 31, 20X1, adjusting entry would be needed to bring the books current at year end? Notice that interest was paid in full through September 30. Therefore, the year-end entry must reflect the accrual of interest for October through December:

12-31-X1	Interest Expense		3,000	
	Interest Payable			3,000
	To record accrued interest at year end for three months ($100,000 X 12% X 3/12)			

When the next interest payment date arrives on March 31, the actual interest payment will cover the previously accrued interest, and additional amounts pertaining to January, February, and March:

3-31-X2	Interest Expense		3,000	
	Interest Payable		3,000	
	Cash			6,000
	To record interest payment (includes accrued interest payable from prior year)			

Any end-of-period entries would also include adjustments of interest expense for the amortization of existing bond premiums or discounts relating to the elapsed time periods.

10.2 Bonds may be Retired Before Scheduled Maturity

Early retirements of debt may occur, because a company has generated sufficient cash reserves from operations, and the company wants to stop paying interest on outstanding debt. Or, interest rates may have changed, and the company wants to take advantage of more favorable borrowing opportunities; you have probably heard of individuals engaging in this type of strategy when they "refinance" a home loan.

Whether the debt is being retired or refinanced in some other way, accounting rules dictate that the retired debt be removed from the books, and that the difference between the debt's net carrying value and the funds paid to retire the debt be recognized as a gain or loss. For instance, assume that Cabano Corporation is retiring $200,000 face of its 6% bonds payable. The last semiannual interest payment occurred on April 30, and the bonds are being retired on June 30, 20X5. The unamortized discount on the bonds at April 30, 20X5, was $6,000, and there was a 5-year remaining life on the bonds as of that date. Further, Cabano is paying $210,000, plus accrued interest, to retire the bonds; this "early call" price was stipulated in the original bond covenant.

The first step to account for this bond retirement is to bring the accounting for interest up to date:

6-30-X5	Interest Expense		2,200	
	Discount on Bonds Payable			200
	Cash			2,000
	To record interest accrual and amortization of discount ($200,000 X 6% X 2/12 months = $2,000; $6,000 discount X 2/60 months = $200)			

Then, the actual bond retirement can be recorded, with the difference between the up-to-date carrying value and the funds utilized being recorded as a loss (debit) or gain (credit).

6-30-X5	Bonds Payable		200,000	
	Interest Payable		2,000	
	Loss on Bond Retirement		15,800	
	Discount on Bonds Payable			5,800
	Cash			212,000
	To record retirement of debt (loss = $210,000 - ($200,000 - $5,800) = $15,800)			

Notice that Cabano's loss relates to the fact that it took a lot more cash ($210,000) to pay off the debt than was the debt's carrying value ($194,200 ($200,000 minus $5,800)).