

CASE 111 Reporting Bond Liabilities On January 1, 2016, Plywood Homes, Inc., Issued 20year, 4 Percent

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Understanding how to properly report bond liabilities is a crucial aspect of financial accounting and reporting. When a company like Plywood Homes, Inc. issues bonds, it must accurately record and disclose the bond liability on its balance sheet, along with related information such as interest expense, amortization of premiums or discounts, and bond maturity details. This article provides a comprehensive overview of how to report bond liabilities, using the case of Plywood Homes, Inc., which issued a 20-year, 4 percent bond on January 1, 2016.

Background of the Bond Issuance

Details of the Bond Issue

On January 1, 2016, Plywood Homes, Inc. issued bonds with the following features:

- Term: 20 years (maturing on December 31, 2035)
- Interest Rate: 4% annually
- Face (Par) Value: Typically \$1,000 per bond (assumed for illustration)
- Issue Price: At par, premium, or discount (assumed to be at par for simplicity)

The issuance of bonds allows Plywood Homes to raise capital for expansion, new projects, or other corporate needs. The company must recognize the bond liability at the amount received from investors and record interest expense over the life of the bonds.

Initial Recognition of Bond Liability

Recording the Bond at Par Value

Since the bonds are issued at face value (assuming \$1,000 per bond), the initial journal entry on January 1, 2016, would be:

Debit: Cash \$[Total issue amount]
Credit: Bonds Payable \$[Total issue amount]

Example: If Plywood Homes, Inc. issues 10,000 bonds at \$1,000 each, the total cash received is \$10,000,000. The entry becomes:

Debit: Cash \$10,000,000
Credit: Bonds Payable \$10,000,000

This records the company's obligation to pay bondholders the principal amount at maturity.

Accounting for Bond Interest

Interest Payments and Expense Recognition

The bonds pay interest annually at a 4% rate. For bonds with a face value of \$1,000, the annual interest expense per bond is:

Interest Payment = Face Value x Coupon Rate = \$1,000 x 4% = \$40

The company records interest expense periodically, typically annually, with the journal entry:

Debit: Interest Expense \$40 per bond
Credit: Cash \$40 per bond

Note: If bonds are issued at par, the interest expense equals the cash interest paid.

Amortization of Premiums or Discounts

When Bonds Are Issued at a Premium or Discount

If bonds are issued at a price different from their face value, the difference must be amortized over the life of the bonds, affecting interest expense and carrying amount.

- Premium Bonds: When bonds are issued above face value, the excess is amortized as a reduction of interest expense.
- Discount Bonds: When issued below face value, the discount is amortized as an increase in interest expense.

Amortization Methods

The effective interest method is preferred for amortization, matching interest expense with the carrying amount of the bonds. The journal entries adjust for amortized amount at each interest payment date.

Reporting Bond Liabilities on the Balance Sheet

Initial Recognition

At issuance, bonds are reported as a long-term liability under the section "Bonds Payable." The carrying amount equals the face value plus or minus any premium or discount.

Subsequent Measurement

Throughout the bond's life, the carrying amount of bonds is adjusted for amortized premiums or discounts. The liability is reported at its amortized cost, reflecting the present value of future payments discounted at the market rate at issuance.

Maturity and Final Payment

At maturity, Plywood Homes, Inc. will pay the bondholders the face value of the bonds, settling the liability. The journal entry on December 31, 2035, would be:

Debit: Bonds Payable	\$10,000,000
Credit: Cash	\$10,000,000

Additional Disclosure Requirements

Notes to Financial Statements

Companies must disclose detailed information regarding bond liabilities, including:

- Terms of bonds (interest rate, maturity date, face value)
- Amortization schedules of premiums or discounts
- Interest expense for each period
- Carrying amount of bonds at reporting date
- Restrictions or covenants related to bond agreements

Impact on Financial Ratios

Proper reporting influences key financial ratios:

- Debt-to-equity ratio
- Interest coverage ratio
- Current ratio (if bonds are classified as current if due within one year)

Conclusion

Effective reporting of bond liabilities, as illustrated by Plywood Homes, Inc., involves accurate initial recognition, periodic interest expense calculation, proper amortization of premiums or discounts, and clear disclosure in financial statements. Adhering to accounting standards such as GAAP ensures transparency and comparability, providing stakeholders with reliable information about the company's financial health.

Understanding these principles helps investors, creditors, and management make informed decisions, assessing the company's leverage, repayment capacity, and overall financial stability. Whether bonds are issued at par, premium, or discount, correct accounting treatment is essential for compliance and clarity in financial reporting.

Keywords: bond liabilities, bond issuance, bond amortization, interest expense, financial reporting, Plywood Homes, bond maturity, GAAP, long-term liabilities

Frequently Asked Questions

What is the appropriate accounting treatment for reporting bond liabilities issued by Plywood Homes, Inc. on January 1, 2016?

Plywood Homes should record the bond liability at its issuance amount, typically the present value of future cash flows, and subsequently report it at amortized cost on the balance sheet, adjusting for any premium or discount over time.

How should Plywood Homes, Inc. account for the 4% bond issued for 20 years in their financial statements?

They should recognize the bond at its issuance date as a liability, initially measured at fair value (often the proceeds received), and then amortize any premium or discount over the bond's life using the effective interest method.

What disclosures are necessary for Plywood Homes, Inc. when reporting bond liabilities in their financial statements?

Disclosures should include the bond's face value, interest rate, maturity date, amortized cost, any premiums or discounts, and details about the repayment schedule and any covenants or restrictions.

How does the issuance of a 20-year, 4% bond impact Plywood Homes' long-term liabilities on the balance sheet?

The bond increases the company's long-term liabilities by the amount of the bond payable, net of any premium or discount, and impacts debt ratios and leverage ratios analyzed by investors and creditors.

What is the significance of the 4% interest rate on the bond issued by Plywood Homes, Inc. in terms of reporting bond liabilities?

The 4% interest rate determines the periodic interest expense recognized over the bond's life, and influences the calculation of the bond's amortized cost, affecting how the liability is reported over time.

If market interest rates change after Plywood Homes, Inc.

issues its 4% bonds, how does this affect the reporting of bond liabilities?

Changes in market interest rates can lead to differences between the bond's carrying amount and its fair value, requiring potential revaluation or disclosure, but the liability remains recorded at amortized cost unless the bonds are classified as fair value through profit or loss.

Additional Resources

Bond Liabilities

Understanding how companies report bond liabilities is fundamental for investors, auditors, and financial analysts alike. When a corporation issues bonds, it enters into a long-term liability arrangement, which must be carefully recorded and presented in financial statements to reflect the company's financial position accurately. Today, we will explore the case of Plywood Homes, Inc., which issued a 20-year, 4% bond on January 1, 2016, and analyze how such bond liabilities are reported, accounted for, and analyzed over time.

Introduction to Bond Issuance and Its Significance

Bonds are a common form of debt financing used by corporations to raise capital for expansion, operations, or other strategic initiatives. When Plywood Homes, Inc. issued its bonds, it committed to paying interest periodically and repaying the principal amount at maturity, which is 20 years later.

Understanding the implications of bond issuance involves examining:

- The terms of the bond (interest rate, maturity, face value)
- How these bonds are initially recorded
- Subsequent amortization of bond premiums or discounts
- The presentation in financial statements
- The impact on financial ratios and company valuation

Details of Plywood Homes, Inc.'s Bond Issue

Let's begin by outlining the key features of the bond:

- Issue Date: January 1, 2016
- Term: 20 years
- Coupon Rate: 4%
- Payment Frequency: Typically semiannual or annual (assuming semiannual for this discussion)
- Face Value (Par Value): Usually \$1,000 per bond (standard unless specified otherwise)

- Interest Payments: Based on the coupon rate and face value
- Maturity Date: December 31, 2035

Initial Recording of the Bond Liability

When Plywood Homes, Inc. issued the bonds, it received cash in exchange for a promise to pay interest and principal in the future. The initial journal entry reflects recording the bond liability at its issue price, which could be at face value, at a premium, or at a discount, depending on the market interest rate at issuance relative to the coupon rate.

2.1. Issuance at Par

If the bonds were issued at face value:

Journal Entry on January 1, 2016:

Account	Debit	Credit
Cash	\$XX	
Bonds Payable		\$XX

Where \$XX represents the face value of the bonds.

2.2. Issuance at Premium or Discount

- Premium: If the bonds' coupon rate exceeds the market rate, investors pay more than face value, resulting in a premium.
- Discount: If the coupon rate is below the market rate, bonds are issued at less than face value.

The initial recording involves:

- Premium: Credit to Bonds Payable and Debit to Cash for the issue price, with the difference recorded as a Premium on Bonds Payable (a contra-liability account).
- Discount: Credit to Bonds Payable and Debit to Cash for the issue price, with the difference recorded as a Discount on Bonds Payable.

Amortization of Bond Premiums and Discounts

Over the life of the bonds, Plywood Homes, Inc. must systematically amortize any premium or discount, reflecting the true cost of borrowing.

2.1. Why Amortize?

- To match interest expense to the period in which it is incurred
- To adjust the book value of the bond liability to its amortized cost
- To ensure that the interest expense reported on the income statement accurately reflects market conditions

2.2. Methods of Amortization

The two primary methods are:

- Effective Interest Method: Preferred by GAAP, it amortizes the premium or discount based on the bond's carrying amount and market rate.
- Straight-Line Method: Simpler but less accurate; not generally acceptable for financial reporting.

Plywood Homes, Inc. would typically use the effective interest method, which involves:

1. Calculating interest expense as:
Carrying amount of the bond $\times$ Market interest rate at issuance
2. Recognizing actual interest paid (coupon payment)
3. Amortizing the difference between the two over the period

2.3. Practical Example

Suppose the bonds were issued at a premium of \$50 over face value:

- Issue Price: \$1,050
- Interest Payment: 4% of \$1,000 = \$40 annually, or \$20 semiannually
- Premium: \$50

Each period, the amortization would adjust the bond's book value, gradually decreasing the premium until maturity, where the bond's carrying amount equals face value.

Subsequent Accounting and Reporting

Once issued, Plywood Homes, Inc. must continuously account for the bond liability.

2.1. Recording Interest Expense

- At each interest payment date, the company records interest expense based on the amortized cost method.
- The journal entry typically involves:

Account	Debit	Credit
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Interest Expense	\$X	
Premium on Bonds Payable (if applicable)		\$Y
Cash		\$Z

Where:

- \$X is the interest expense calculated via the effective interest method
- \$Y is the amortized amount of the premium or discount
- \$Z is the actual cash interest paid

2.2. Adjusting the Bond Liability

- The bond's carrying amount is adjusted each period by the amortized amount.
- The balance sheet reflects the amortized cost of the bonds, which may differ from the face value until maturity.

Presentation in Financial Statements

Accurate reporting of bond liabilities is critical for transparent financial statements. The presentation includes:

2.1. Balance Sheet

- Bonds payable are reported as a long-term liability, at amortized cost.
- If a premium or discount exists, it is included in the carrying amount.
- The balance sheet may present:

- > Long-term liabilities:
- > Bonds payable (net of unamortized premium/discount)

2.2. Income Statement

- Interest expense is reported, reflecting the amortized cost method.
- The difference between cash interest paid and interest expense (due to amortization) affects net income.

2.3. Notes to Financial Statements

- Detailed disclosures on bond terms, maturity schedule, interest rates, and amortization methods.
- Information about the carrying amount of bonds, any premiums or discounts, and redemption provisions.

Impact on Financial Ratios and Company Valuation

Bond liabilities influence several key financial ratios:

- Debt-to-Equity Ratio: Increases as bonds are issued.
- Interest Coverage Ratio: Affected by interest expense, impacting perceived profitability.
- Leverage and Solvency: Long-term bonds increase leverage but also provide capital for growth.

Investors analyze these ratios to assess Plywood Homes, Inc.'s financial stability and risk profile.

Redemption and Maturity of Bonds

At the end of the 20-year term, Plywood Homes, Inc. will:

- Redeem the bonds at face value (assuming no early redemption)
- Pay the final interest installment
- Remove the bond liability from the books

If bonds are callable or convertible, additional accounting rules apply, potentially affecting the timing and recognition of gains or losses.

Special Considerations and Potential Challenges

While the above outlines standard procedures, certain complexities can arise:

- Early Redemption: If Plywood Homes, Inc. chooses to call bonds before maturity, they may incur a loss or gain depending on the bond's carrying amount versus the redemption price.
- Changes in Market Rates: Fluctuations affect the fair value of bonds, especially if they are traded before maturity.
- Accounting for Convertible Bonds: If bonds are convertible, additional entries are necessary upon conversion.

Conclusion: Best Practices in Reporting Bond Liabilities

Accurate and transparent reporting of bond liabilities requires meticulous attention to detail:

- Proper initial recording at issue price
- Consistent amortization of premiums or discounts using the effective interest method
- Clear disclosures in financial statements
- Ongoing monitoring of market conditions and covenant compliance

For Plywood Homes, Inc., issuing a 20-year, 4% bond is a strategic move that impacts their long-term

financial health. Proper accounting ensures stakeholders have a clear view of obligations and the company's capacity to meet them.

By adhering to these principles, organizations can maintain integrity in their financial reporting, support investor confidence, and comply with regulatory standards.

In summary, the reporting of bond liabilities like those issued by Plywood Homes, Inc. involves a comprehensive process that includes initial recognition, amortization, presentation, and eventual settlement. Mastery of these elements is essential for accurate financial analysis and sound corporate governance.

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