

Suspect Company Issued \$960,000 Of 10 Percent First Mortgage Bonds On January 1, 20X1, At 104. The Bonds

Suspect Company Issued \$960,000 Of 10 Percent First Mortgage Bonds On January 1, 20X1, At 104. The Bonds marked a significant milestone in the company's financing activities, providing a strategic infusion of capital to support its growth initiatives. This issuance reflects a well-calculated move to leverage debt financing, offering investors a secure and profitable investment opportunity backed by the company's real estate assets. In this comprehensive article, we will explore the details of this bond issuance, its implications for Suspect Company, and the broader context of mortgage bonds in corporate finance.

Understanding First Mortgage Bonds

What Are First Mortgage Bonds?

First mortgage bonds are a type of secured debt instrument backed by a company's real estate assets. These bonds are considered to be low-risk investments because they have priority over other unsecured debt in the event of liquidation. The key features include:

- Security: Collateralized by specific property or real estate assets.
- Priority: Hold first claim on collateral during bankruptcy or liquidation.
- Interest Rate: Typically fixed, providing predictable income.
- Maturity: Usually long-term, with maturity dates often spanning several years.

Advantages for Investors and the Company

For investors:

- Enhanced security due to collateral backing.
- Fixed interest payments provide steady income.
- Priority claim reduces risk in default scenarios.

For the issuing company:

- Access to large amounts of capital.
- Favorable interest rates compared to unsecured debt.
- Potentially lower borrowing costs due to secured status.

Details of Suspect Company's Bond Issuance

Key Features of the Bonds

The bonds issued by Suspect Company on January 1, 20X1, included several defining features:

- Principal Amount: \$960,000.
- Interest Rate: 10 percent annually.
- Issue Price: 104 (which signifies 104% of face value).
- Maturity Date: Typically, a period of 10-20 years (specific maturity date would be detailed in the bond agreement).
- Type: First mortgage bonds secured by company real estate.
- Interest Payment: Usually semiannual or annual payments.

Pricing and Premium

The bonds were issued at 104, indicating they were sold at a 4% premium over the face value. This premium reflects several factors:

- Market Conditions: Investors were willing to pay more for bonds with attractive interest rates and security.
- Company Creditworthiness: Suspect Company's financial stability and asset backing enhanced investor confidence.
- Demand for Mortgage Bonds: Strong demand for secured bonds may have driven the premium.

The premium impacts the initial accounting entries and affects the effective yield to investors, which may differ slightly from the stated coupon rate.

Financial Implications of the Bond Issuance

Impact on Suspect Company's Financial Statements

The bond issuance affects multiple aspects of the company's financial statements:

1. Cash Flow:

- Increase by the gross proceeds: $\$960,000 \times 104\% = \$998,400$.
- Net proceeds after deducting issuance costs (if any).

2. Liabilities:

- Increase in long-term liabilities by the face amount, \$960,000.
- Premium on Bonds Payable: $\$960,000 \times 4\% = \$38,400$ (additional liability component).

3. Balance Sheet:

- Assets increase by the amount of cash received.
- Liabilities increase correspondingly, with the bonds recorded at face value plus premium.

4. Interest Expense:

- The effective interest method will amortize the premium over the bond's life, affecting periodic interest expense.

Journal Entries on Bond Issuance

To record the issuance, Suspect Company would typically make the following entries:

- At issuance:

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Debit Cash: \$998,400

Credit Bonds Payable (face value): \$960,000

Credit Premium on Bonds Payable: \$38,400

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- Interest payments (assuming semiannual):

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Debit Interest Expense (amortized amount)

Credit Cash (interest payment): \$48,000 (10% of \$960,000 annually divided by 2)

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Proper amortization of the premium reduces interest expense over the bond's life, reflecting the effective interest rate.

Strategic Reasons for Issuing Bonds at a Premium

Market Conditions Favoring Premium Issuance

Issuing bonds at a premium often indicates favorable market conditions, including:

- High investor demand for secured bonds.
- Attractive interest rates relative to market averages.
- Strong company credit ratings or asset backing.

Financial Strategy Benefits

- Lower Effective Cost of Borrowing: Although the bonds pay 10%, the premium effectively reduces the company's interest expense over time.
- Enhanced Investor Confidence: A premium suggests the bonds are in high demand, signaling trust in the company's stability.
- Flexibility in Debt Management: The company can plan interest payments and amortization

strategies to optimize cash flow.

Legal and Regulatory Considerations

Bond Covenants and Restrictions

Mortgage bonds often include covenants to protect bondholders, such as:

- Restrictions on additional debt issuance.
- Maintenance of certain financial ratios.
- Limitations on asset disposal.

Compliance and Disclosure

Issuers must adhere to securities regulations, including:

- Accurate disclosure of bond terms.
- Periodic reporting of financial condition.
- Compliance with accounting standards, such as GAAP or IFRS.

Broader Context of Mortgage Bond Issuances in Corporate Finance

Role in Capital Structure

Mortgage bonds are a crucial component of a company's capital structure, providing:

- Debt financing backed by tangible assets.
- Lower cost of capital compared to unsecured bonds.
- Diversification of funding sources.

Market Trends and Investor Preferences

- Growing demand for secured bonds due to perceived safety.
- Increased issuance during economic stability.
- Use of mortgage bonds for real estate development and acquisition financing.

Risks and Considerations

While mortgage bonds are secured, they are not risk-free. Key risks include:

- Decline in real estate values.
- Default risk if the company faces financial distress.
- Legal complexities in foreclosure procedures.

Conclusion: Significance of Suspect Company's Bond Issuance

The issuance of \$960,000 of 10 percent first mortgage bonds at 104 by Suspect Company on January 1, 20X1, exemplifies a strategic approach to debt financing. By leveraging secured bonds backed by real estate assets, the company secured favorable borrowing terms, increased its capital base, and enhanced its financial flexibility. For investors, these bonds offered a secure, income-generating investment opportunity, especially given the premium pricing and security features.

This transaction highlights the importance of understanding mortgage bonds' mechanics, their role in corporate finance, and the strategic considerations behind issuing bonds at a premium. As Suspect Company continues to grow, these bonds will serve as a foundation for its ongoing projects and expansion plans, demonstrating prudent financial management and investor confidence.

Key Takeaways:

- Mortgage bonds provide secured financing backed by real estate assets.
- Issuing bonds at a premium reflects strong market demand and company confidence.
- Proper accounting for bond issuance involves recording cash, liabilities, and premium.
- Mortgage bonds are vital tools for companies seeking long-term, secure debt financing.
- Investors should assess collateral, interest rates, and covenants when evaluating mortgage bonds.

SEO Keywords: mortgage bonds, first mortgage bonds, bond issuance, bond premium, secured debt, Suspect Company, corporate financing, bond market, real estate-backed bonds, debt financing strategies

Frequently Asked Questions

What does it mean that the bonds were issued at 104?

Issuing bonds at 104 indicates that the bonds were sold at 104% of their face value, meaning the company received 4% more than the principal amount, or $\$960,000 \times 1.04 = \$998,400$.

What is the significance of the 10 percent rate on these first mortgage bonds?

The 10 percent rate indicates the annual interest rate the company will pay to bondholders, which on a \$960,000 principal amounts to \$96,000 annually.

How do issuing bonds at a premium (above face value) affect the company's financial statements?

Issuing bonds at a premium results in additional cash received (above face value), which is recorded as a liability and amortized over the bond's life, affecting interest expense and bond payable accounts.

What journal entry should the company record on January 1, 20X1, upon issuing the bonds?

Debit Cash \$998,400, credit Bonds Payable \$960,000, and credit Premium on Bonds Payable \$38,400 (the difference between cash received and face value).

How is the bond discount or premium amortized over the life of the bonds?

The premium (or discount) is amortized using the effective interest method, spreading the premium over the bond's term to reflect the interest expense accurately each period.

What are the key financial ratios impacted by issuing these bonds at a premium?

Ratios such as debt-to-equity, interest coverage ratio, and earnings per share can be affected, as the premium impacts liabilities and interest expense over time.

When will the company pay the interest on these bonds?

Interest is typically paid semiannually or annually, so the company will make interest payments of \$96,000 per year, usually split into two payments of \$48,000 each if semiannual.

What is the maturity date of these bonds if issued on January 1, 20X1?

The maturity date isn't specified in the question, but generally, first mortgage bonds are issued with a fixed maturity date, often 10, 20, or 30 years from issuance, which should be specified in the bond agreement.

What are the advantages for the company to issue bonds at a

premium?

Issuing bonds at a premium lowers the effective interest rate paid by the company, reduces interest expense over the life of the bonds, and can improve the company's financial ratios.

What disclosures are necessary in the financial statements regarding these bonds?

Disclosures should include the terms of the bonds, the amount issued, interest rate, maturity date, premium or discount, and any covenants or restrictions associated with the bonds.

Additional Resources

Suspect Company Issued \$960,000 Of 10 Percent First Mortgage Bonds On January 1, 20X1, At 104. The Bonds—a scenario that combines key elements of bond issuance, valuation, and accounting treatment—serves as an instructive example for understanding corporate debt financing. This article provides a comprehensive breakdown of this transaction, exploring its implications, accounting considerations, and related concepts to help readers grasp the nuances involved in bond issuance at a premium.

Understanding the Bond Issuance: Basic Facts and Terminology

Before diving into detailed analysis, let's clarify the core details of the bond issuance:

- Issuer: Suspect Company
- Issue Date: January 1, 20X1
- Principal (Face Value): \$960,000
- Coupon Rate: 10% per annum
- Type of Bonds: First Mortgage Bonds (secured by property)
- Issue Price: 104 (which means 104% of face value)
- Total Proceeds: $\$960,000 \times 1.04 = \$998,400$

In essence, Suspect Company issued bonds with a face value of \$960,000 but sold them at a premium, receiving more than the face value—specifically, at 104% of the face amount.

Why Issue Bonds at a Premium?

Issuing bonds at a premium occurs when the coupon rate exceeds the prevailing market interest rates, making the bonds more attractive to investors. In this case:

- Coupon Rate: 10%
- Issue Price: 104% of face value, indicating investors are willing to pay extra for the bonds, likely due to favorable market conditions or the company's strong creditworthiness.

The premium compensates the bondholders for the higher-than-market coupon rate, and the issuer benefits by lowering their effective interest expense over the bond's life.

Calculating the Proceeds and Premium

The total proceeds from the bond issue are crucial for financial analysis and journal entries.

Proceeds:

$$- \$960,000 \times 104\% = \$998,400$$

Premium on Bonds Payable:

$$- \$998,400 \text{ (proceeds)} - \$960,000 \text{ (face value)} = \$38,400$$

This premium is recorded as a liability that will be amortized over the life of the bonds, affecting interest expense and carrying amount.

Accounting for Bond Issuance

Proper recording of bond issuance involves recognizing the liability and the premium.

Initial Journal Entry (at issuance):

- Debit: Cash \$998,400
- Credit: Bonds Payable \$960,000
- Credit: Premium on Bonds Payable \$38,400

This entry reflects the receipt of cash, the obligation to pay back face value, and the premium received.

Interest Payments and Amortization

The bonds pay interest annually at 10%, which equates to:

- Annual Coupon Payment: $\$960,000 \times 10\% = \$96,000$

Since bonds are issued at a premium, the effective interest expense recognized over time will be less than the cash interest paid, due to amortization of the premium.

Amortization Methods:

- Straight-Line Method: Equal amount of premium amortized each period.
- Effective Interest Method: Interest expense based on the carrying amount and market rate.

Most companies prefer the effective interest method, as it reflects a more accurate matching of expenses.

Calculating the Amortization of Premium Using Effective Interest Method

The key steps involve:

1. Determine the market rate at issuance (implicit in premium).
2. Calculate the interest expense for each period.
3. Deduct the interest expense from cash paid to find amortized premium.

Assumption: For this example, if the bonds' effective interest rate is approximately 9.5% (since bonds issued at a premium reflect a lower market rate than 10%), then:

- Interest Expense for Year 1: $\$998,400 \times 9.5\% \approx \$94,848$
- Cash Interest Paid: $\$96,000$
- Premium Amortized: $\$96,000 - \$94,848 \approx \$1,152$

Adjusting the Carrying Amount:

- New carrying amount after Year 1: $\$998,400 - \$1,152 \approx \$997,248$

This process continues over the life of the bonds, gradually reducing the premium until the carrying amount equals the face value at maturity.

Impact on Financial Statements

Balance Sheet:

- Bonds Payable (at face value): $\$960,000$
- Premium on Bonds Payable: reduces the net liability over time

- Total liabilities increase by the proceeds received (\$998,400)

Income Statement:

- Interest expense recognizes the amortized amount
- The difference between cash interest and expense reflects the amortization of premium

Cash Flow Statement:

- Operating activities: interest paid (\$96,000 annually)
- Financing activities: proceeds from bond issuance

Implications for Investors and the Company

For the Bondholders:

- Receive fixed interest payments of \$96,000 annually
- Face repayment of \$960,000 at maturity
- Benefit from the premium paid upfront, indicating perceived safety or favorable terms

For the Company:

- Access to additional funds (\$998,400 vs. face value of \$960,000)
- Slightly reduced effective interest expense due to amortization of premium
- Obligations secured by first mortgage, providing creditor security

Potential Risks and Considerations

- Interest Rate Fluctuations: If market rates decline, issuing bonds at a premium indicates the company's bonds are more attractive, but future refinancing could be costly.
- Amortization Impact: The premium amortized over the bond's life affects interest expense and net income.
- Refinancing Risks: If the company cannot meet interest payments or repay principal at maturity, it could face default.

Summary and Key Takeaways

- Issuing bonds at 104 means the company sold bonds at a premium, reflecting favorable market

conditions or strong credit.

- The initial journal entry recognizes the proceeds and premium, affecting the company's liabilities.
- Effective interest method provides a systematic way to amortize the premium, aligning interest expense with market rates.
- The premium reduces interest expense over time, impacting the company's net income.
- Proper accounting treatment ensures transparent financial reporting and compliance with accounting standards.

Final Thoughts

The issuance of bonds at a premium, such as in the case of Suspect Company's \$960,000 of 10% first mortgage bonds issued at 104, exemplifies sound financial strategy and careful accounting. Recognizing the premium and amortizing it appropriately over the life of the bonds provides a realistic picture of the company's financial obligations and costs of borrowing. For investors, understanding these nuances aids in making informed decisions, while for the issuing company, it underscores the importance of strategic financing and accurate financial reporting.

In summary, the issuance of bonds at a premium involves understanding the interplay between bond pricing, interest calculations, and accounting treatment. Whether you're a student, accountant, or investor, grasping these concepts enhances your ability to analyze corporate debt instruments effectively.

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