

On January 1, 2020, Cheyenne, Inc, Purchased 9% Bonds Having A Maturity Value Of \$467,000 For \$482,467.83.

On January 1, 2020, Cheyenne, Inc, Purchased 9% Bonds Having A Maturity Value Of \$467,000 For \$482,467.83. This significant financial transaction highlights the strategic investment decisions made by Cheyenne, Inc., and offers valuable insights into bond investing, accounting treatment, and the implications for both the company's financial statements and investment portfolio. In this comprehensive article, we will explore the details of this bond purchase, analyze the key concepts involved, and discuss the broader implications for investors and financial professionals.

Understanding the Bond Purchase by Cheyenne, Inc.

Details of the Bond Investment

On January 1, 2020, Cheyenne, Inc. acquired bonds with the following characteristics:

- Coupon rate: 9%
- Maturity value (Face value): \$467,000
- Purchase price: \$482,467.83
- Interest payment schedule: Typically semiannual or annual
- Maturity date: To be specified (assuming a standard term, e.g., 10 years)

This purchase reflects Cheyenne, Inc.'s intent to earn periodic interest income and realize capital gains (or losses) over the bond's life, depending on market conditions and the bond's face value relative to the purchase price.

Why Did Cheyenne, Inc. Pay a Premium?

The purchase price of \$482,467.83 exceeds the bond's maturity value of \$467,000 by approximately \$15,467.83. This premium indicates:

- The bond's coupon rate (9%) is higher than prevailing market interest rates at the time, making the bond more attractive.
- Investors are willing to pay more to secure higher interest income, especially if comparable bonds offer lower yields.
- The premium compensates for the difference between the coupon payments and the current market rate, aligning the bond's yield to market conditions.

Accounting for Bond Investments: Key Concepts

Premium on Bonds Payable

When bonds are purchased at a premium, the excess amount over the face value is recorded as:

- A debit to the "Investment in Bonds" asset account.
- A credit to a "Premium on Bonds" account, which is a contra-liability or adjunct to the bond liability, depending on accounting standards.

Amortization of Premium

The premium on bonds is amortized over the life of the bond using methods such as:

- Effective interest method: Recognizes interest income based on the bond's carrying amount and the market rate at purchase.
- Straight-line method: Allocates equal amounts of premium amortization each period, though less accurate.

Amortization reduces the bond's carrying amount gradually until it equals the maturity value at maturity.

Interest Income Recognition

Cheyenne, Inc. will recognize interest income periodically:

- Based on the bond's effective yield (which considers the premium).
- The actual cash interest received equals the coupon rate multiplied by the face value ($\$467,000 \times 9\% = \$42,030$ annually).

Over time, the interest income recognized will differ from the cash received due to premium amortization.

Financial Impact of the Bond Purchase

Initial Recording of the Investment

At the purchase date, Cheyenne, Inc. records:

- Debit: Investment in Bonds — \$482,467.83
- Credit: Cash — \$482,467.83

The premium on bonds is embedded within the carrying amount of the investment and will be amortized over the bond's life.

Interest Income and Premium Amortization

Suppose the bond pays interest semiannually:

- Each period, Cheyenne, Inc. recognizes interest income based on the effective interest method.
- The amortization of the premium reduces the bond's carrying amount, gradually decreasing the difference between the bond's book value and its face value.

Impact on Financial Statements

- Balance Sheet: The bond investment appears as a non-current asset initially, with the carrying amount adjusted over time.
- Income Statement: Interest income increases periodically, reflecting the effective yield.
- Cash Flows: Cash interest payments are recorded as operating or investing cash flows, depending on the company's accounting policies.

Strategic Considerations for Bond Investments

Benefits of Purchasing Bonds at a Premium

- Higher periodic interest income compared to bonds bought at par or at a discount.
- Potential for capital gains if the bond is held to maturity and the premium amortizes to zero.

Risks and Challenges

- Market interest rate fluctuations can impact the bond's fair value.
- Credit risk associated with the bond issuer.
- Reinvestment risk if interest rates decline.

Long-term Investment Strategy

Investing in bonds like those purchased by Cheyenne, Inc. can serve various strategic purposes:

- Portfolio diversification
- Income generation
- Preservation of capital
- Meeting specific liability obligations

Tax Implications of Bond Investments

Interest Income Taxation

Interest earned from bonds is generally taxable as ordinary income, unless the bonds are tax-exempt municipal bonds.

Premium Amortization and Tax

- Premium amortization may reduce taxable interest income.
- Tax laws vary; companies should consult tax professionals to understand the implications.

Conclusion: The Significance of Cheyenne, Inc.'s Bond Purchase

Cheyenne, Inc.'s purchase of 9% bonds with a maturity value of \$467,000 for \$482,467.83 exemplifies strategic bond investing, emphasizing the importance of understanding premium pricing, amortization methods, and their impact on financial reporting. Such investments can enhance a company's income streams, diversify its portfolio, and serve as a critical component of its overall financial management strategy.

Investors and financial professionals should analyze bond purchases holistically, considering yield, market conditions, risk factors, and accounting treatments. By doing so, they can optimize investment outcomes and ensure accurate financial reporting aligned with applicable standards.

Additional Resources for Bond Investment Strategies

- Investopedia: Comprehensive guides on bond investing
- Financial Accounting Standards Board (FASB): Accounting standards for debt securities
- SEC Filings: Public company disclosures on bond holdings
- Professional Financial Advisors: Tailored investment advice

Understanding the intricacies of bond transactions like Cheyenne, Inc.'s purchase is essential for making informed financial decisions, managing risks, and maximizing returns. Whether for corporate treasury management or individual investing, mastering bond accounting and strategic considerations remains vital in today's dynamic financial environment.

Frequently Asked Questions

What was the purchase price of Cheyenne, Inc's bonds

on January 1, 2020?

Cheyenne, Inc purchased the bonds for \$482,467.83.

What is the maturity value of the bonds purchased by Cheyenne, Inc?

The maturity value of the bonds is \$467,000.

What is the stated interest rate on the bonds purchased by Cheyenne, Inc?

The bonds have a 9% interest rate.

Was Cheyenne, Inc's purchase of bonds at a premium, discount, or at par?

Cheyenne, Inc purchased the bonds at a premium since the purchase price (\$482,467.83) exceeds the maturity value (\$467,000).

How do you calculate the premium paid on the bonds?

The premium is calculated as the purchase price minus the face value: $\$482,467.83 - \$467,000 = \$15,467.83$.

What is the significance of the bond's coupon rate in this transaction?

The 9% coupon rate indicates the annual interest income Cheyenne, Inc will receive based on the bond's face value.

How would Cheyenne, Inc record the bond purchase in their accounting books?

They would debit the Investment in Bonds account for \$482,467.83 and credit Cash for the same amount.

What is the effective interest rate implied by the purchase price?

Since the bonds were purchased at a premium, the effective interest rate is slightly lower than the stated 9% coupon rate.

When will Cheyenne, Inc receive the bond's interest

payments?

Interest payments are typically made semiannually or annually, based on the bond's terms, which are not specified here.

Additional Resources

On January 1, 2020, Cheyenne, Inc, Purchased 9% Bonds Having A Maturity Value Of \$467,000 For \$482,467.83.

In the world of corporate finance and investment, bond transactions are pivotal events that can influence a company's financial health and strategic positioning. On the first day of 2020, Cheyenne, Inc. embarked on such a transaction by purchasing bonds with a face value of \$467,000 at a price exceeding their maturity value, paying a total of \$482,467.83. This article offers a comprehensive exploration of this transaction, its accounting implications, and the principles underlying bond investments, providing insights for finance professionals, students, and investors alike.

Understanding Bond Investments: Basic Concepts

Before delving into the specifics of Cheyenne, Inc.'s purchase, it is essential to grasp foundational concepts related to bonds and their valuation.

What Are Bonds?

Bonds are debt securities issued by entities—corporations, municipalities, or governments—to raise capital. When an investor buys a bond, they are effectively lending money to the issuer in exchange for periodic interest payments and the return of the principal amount at maturity.

Key Features of Bonds

- Face (Maturity) Value: The amount payable at maturity, also known as the par value or principal.
- Coupon Rate: The annual interest rate paid by the bond, expressed as a percentage of face value.
- Issue Price: The price at which the bond is initially sold; it can be at par, premium, or discount relative to face value.
- Maturity Date: The date when the bond's face value is repaid.

Bond Pricing and Premiums/Discounts

Bonds may trade at:

- Par (at face value): When the market interest rate equals the coupon rate.
- Premium: When the market interest rate is lower than the coupon rate, causing the bond to sell above face value.
- Discount: When the market interest rate exceeds the coupon rate, leading to a sale below

face value.

In Cheyenne's case, the bond was purchased for more than its maturity value, indicating a premium.

The Details of Cheyenne, Inc.'s Bond Purchase

Let's analyze the specifics:

- Maturity (Face) Value: \$467,000
- Coupon Rate: 9%
- Purchase Price: \$482,467.83
- Purchase Date: January 1, 2020

Given these, the bond pays 9% interest annually on its face value, equating to:

$$\text{Annual Interest} = \$467,000 \times 9\% = \$42,030$$

Why Did Cheyenne, Inc. Pay a Premium?

Paying \$482,467.83 for bonds with a face value of \$467,000 means Cheyenne, Inc. acquired the bonds at a premium of:

$$\text{Premium} = \$482,467.83 - \$467,000 = \$15,467.83$$

This premium suggests that the bond's coupon rate (9%) is higher than prevailing market interest rates at the time of purchase, making the bonds more attractive and thus commanding a higher price.

Implications:

- The premium reflects the excess over face value paid by Cheyenne, Inc.
- Over time, as the bonds approach maturity, this premium will be amortized, affecting interest income recognition.

Accounting for the Bond Purchase: Journal Entries

Proper accounting treatment is vital to accurately reflect the transaction in Cheyenne's financial statements.

Initial Recognition

On January 1, 2020, Cheyenne will record the purchase as follows:

- Debit: Investment in Bonds — \$482,467.83

- Credit: Cash — \$482,467.83

This records the outflow of cash in exchange for the bond investment.

Amortization of the Premium: The Core Concept

Since the bond was purchased at a premium, Cheyenne must amortize this premium over the bond's remaining life to match interest income with the effective yield.

Methods of Amortization

Two primary methods are used:

1. Straight-Line Method: Equal amortization each period; simpler but less precise.
2. Effective Interest Method: Amortizes the premium based on the bond's effective yield, providing more accurate income recognition.

The effective interest method is standard under generally accepted accounting principles (GAAP). It considers the bond's yield rate, which may differ from the coupon rate.

Calculating the Effective Interest Rate

To understand the amortization process, Cheyenne must determine the bond's effective yield at purchase.

Using the given data:

- Purchase price: \$482,467.83
- Face value: \$467,000
- Coupon rate: 9%
- Annual coupon payment: \$42,030

The effective interest rate (yield) can be approximated by solving the present value of future cash flows equal to the purchase price, often via financial calculator or spreadsheet.

Approximate Yield Calculation:

- The present value (PV) of the bond's cash flows (interest + face value) discounted at the yield (Y) equals the purchase price:

$$PV = \sum_{t=1}^n \frac{\text{Interest Payment}}{(1 + Y)^t} + \frac{\text{Face Value}}{(1 + Y)^n}$$

Assuming the bond matures in, say, 10 years, we can estimate the yield using financial tools. For simplicity, assume an approximate yield around 8.5%—less than the coupon rate, consistent with the bond selling at a premium.

Recording Interest Income and Premium Amortization

Each period, Cheyenne will:

- Recognize interest income based on the effective interest rate applied to the book value of the bond.
- Amortize part of the premium, reducing the bond's book value over time.

Sample journal entry for interest recognition (annually):

- Debit: Investment in Bonds — \$X (amortized premium)
- Credit: Interest Income — \$Y (effective interest)

Where:

- $Y = \text{Book value} \times \text{Effective interest rate}$
- $X = \text{Interest payment} - Y$

This process continues until the bond matures, at which point the bond's book value equals its face value, and the premium is fully amortized.

Implications for Cheyenne, Inc.'s Financial Statements

The purchase impacts multiple financial statement components:

Balance Sheet

- Investment in Bonds (Non-Current Asset): Initially recorded at \$482,467.83.
- Amortized Premium: Gradually reduces the book value over the bond's life.

Income Statement

- Interest Income: Recognized based on the effective interest rate, which may differ from the coupon payment.
- Premium Amortization: Reduces interest income over time, affecting net income.

Cash Flows

- The initial purchase is a cash outflow.
- Interest received during the bond's life is a cash inflow.

Strategic Considerations for Cheyenne, Inc.

Investing in bonds at a premium offers both opportunities and risks:

- Higher Yield: The effective yield can be higher than the coupon rate if the premium is amortized effectively.
- Interest Rate Risk: Fluctuations in interest rates can affect the bond's fair value.
- Credit Risk: The issuer's creditworthiness influences the bond's safety.

Cheyenne's decision to purchase bonds at a premium indicates they valued the bonds higher than their face value, possibly due to favorable market conditions or a desire for steady income.

Conclusion: The Broader Context

Cheyenne, Inc.'s bond purchase on January 1, 2020, exemplifies a typical investment strategy involving premium bonds. It underscores the importance of understanding bond valuation, the necessity of proper accounting treatments—particularly premium amortization—and the influence of market interest rates on bond pricing.

For investors and companies alike, such transactions require meticulous analysis and precise recording to ensure financial statements accurately reflect economic realities. As the bonds mature, Cheyenne will recognize the full face value, and the premium will be fully amortized, impacting future income recognition.

In an evolving financial landscape, mastering these concepts enables stakeholders to make informed decisions, optimize investment returns, and maintain transparency in financial reporting.

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