

On December 31 Wintergreen, Incorporated, Issued \$150,000 Of 7 Percent, 10-year Bonds For Cash Of \$139,875.

On December 31 Wintergreen, Incorporated, Issued \$150,000 Of 7 Percent, 10-year Bonds For Cash Of \$139,875. This transaction marks a significant event in the company's financial activities, reflecting its approach to funding long-term projects and managing debt. Understanding the details of this bond issuance provides insight into corporate finance strategies, bond valuation, and accounting treatment for debt securities. In this article, we will explore the specifics of this bond issuance, the concept of bond discounts, and the implications for Wintergreen, Incorporated's financial statements.

Overview of Bond Issuance by Wintergreen, Incorporated

Details of the Bond Issue

Wintergreen, Incorporated issued bonds with the following key terms:

- Bond Principal (Face Value): \$150,000
- Interest Rate (Coupon Rate): 7% annually
- Term of Bonds: 10 years
- Issue Date: December 31
- Cash Received (Issue Price): \$139,875

This issuance indicates that Wintergreen is raising funds through debt, promising to pay interest annually and repay the principal at maturity after ten years.

Understanding the Issue Price and Bond Discount

Notice that the bonds were issued at a cash amount of \$139,875, which is less than the face value of \$150,000. This difference signifies that the bonds were issued at a discount:

- **Bond Discount:** $\$150,000$ (face value) - $\$139,875$ (cash received) = $\$10,125$
- **Discount Rate:** The discount reflects the difference between the bond's face value and its issue price, representing the effective yield to investors compared to the stated coupon rate.

Issuing bonds at a discount typically occurs when the coupon rate is below the prevailing market

interest rate, making the bonds less attractive unless sold at a discount.

Implications of Bond Discount on Financial Statements

Accounting for Bond Discount

When bonds are issued at a discount, Wintergreen must record the bond liability at its cash received amount and recognize the discount as a contra-liability account:

- **Journal Entry at Issue:**

- Debit Cash: \$139,875
- Debit Discount on Bonds Payable: \$10,125
- Credit Bonds Payable: \$150,000

This setup reflects the total liability of \$150,000, with the discount amount amortized over the life of the bonds.

Amortization of the Discount

Over the 10-year life of the bonds, Wintergreen will amortize the discount, effectively increasing interest expense to match the market rate. The amortization can be calculated using methods such as:

- **Straight-Line Method:** Equal amount of discount amortized each period.
- **Effective Interest Method:** Interest expense varies based on the carrying amount and market rate, providing a more accurate reflection of the cost of borrowing.

For example, using the effective interest method, the interest expense each period would be higher than the cash interest paid, recognizing the amortization of the discount.

Interest Payments and Financial Impact

Annual Interest Payments

Wintergreen, Incorporated will pay interest annually based on the face value and coupon rate:

- Annual Coupon Payment: $\$150,000 \times 7\% = \$10,500$

Interest payments are made at the end of each year, and these cash outflows are recorded as interest expense adjusted for amortization.

Impact on Earnings and Cash Flows

The difference between interest expense (which increases due to discount amortization) and the actual cash interest paid impacts the company's net income:

- **Interest Expense:** Higher than \$10,500 in the initial years due to amortization of the discount.
- **Cash Outflow:** Consistent interest payments of \$10,500 annually.

This discrepancy leads to an increase in reported interest expense over the bond's life, affecting profitability metrics.

Long-Term Implications of Bond Issuance

Debt Management and Financial Ratios

Issuing bonds affects a company's leverage ratios and overall financial health:

- Increases liabilities, impacting debt-to-equity ratios.
- Potentially improves liquidity if the proceeds are used for growth initiatives.
- Requires careful management to ensure debt obligations are met over the bond term.

Refinancing and Market Conditions

Market interest rates fluctuate, and the initial discount may reflect expectations of future rate changes:

- If interest rates decline after issuance, Wintergreen might consider refinancing at lower rates.
- The company must evaluate its ability to meet scheduled interest payments and principal repayment at maturity.

Conclusion: Strategic Significance of the Bond Issue

The issuance of \$150,000 of 7 percent, 10-year bonds at a cash price of \$139,875 by Wintergreen, Incorporated, exemplifies a strategic approach to financing long-term growth. By understanding the bond's discount, amortization process, and impact on financial statements, stakeholders can better

evaluate the company's financial health and its ability to meet future obligations.

This bond issuance also illustrates broader principles of corporate finance:

- Market conditions influence bond pricing and issuance strategies.
- Debt financing, when managed effectively, can support expansion while maintaining financial stability.
- Accurate accounting for bond discounts and interest expense ensures transparency and compliance with accounting standards.

In summary, the December 31 bond issuance by Wintergreen, Incorporated, is a vital event that underscores the importance of understanding bond valuation, amortization, and their implications on a company's financial position. Whether for investors, financial analysts, or company management, grasping these concepts is essential for making informed decisions and ensuring sustainable growth.

Frequently Asked Questions

Why did Wintergreen, Incorporated issue bonds at a price below their face value?

Wintergreen issued the bonds at \$139,875, which is below the \$150,000 face value, because the bonds likely had a coupon rate (7%) that was lower than the prevailing market interest rates, resulting in a discount to attract investors.

What is the significance of the bond's 10-year maturity for Wintergreen, Incorporated?

The 10-year maturity indicates that Wintergreen's bonds will mature and repay the principal of \$150,000 after 10 years, affecting the company's long-term liabilities and interest expense over that period.

How does issuing bonds at a discount affect Wintergreen's financial statements?

Issuing bonds at a discount increases the company's liabilities and results in the bond discount being amortized over the bond's life, which increases interest expense and affects net income over time.

What accounting entries would Wintergreen record upon issuing these bonds?

Wintergreen would record a debit to Cash for \$139,875, a debit to Discount on Bonds Payable for the difference (\$10,125), and a credit to Bonds Payable for \$150,000 to reflect the issuance at a discount.

What are the potential advantages for Wintergreen, Incorporated in issuing bonds instead of equity?

Issuing bonds allows Wintergreen to raise capital without diluting ownership, often results in tax-deductible interest payments, and can be a cost-effective way to finance long-term projects if interest rates are favorable.

Additional Resources

On December 31, Wintergreen, Incorporated, issued \$150,000 of 7 percent, 10-year bonds for cash of \$139,875. This transaction is a classic example of corporate bond issuance and offers valuable insights into how companies raise capital through debt financing, how bond issuance affects financial statements, and what accounting considerations come into play. In this comprehensive guide, we will analyze the details of this bond issuance, explain the underlying concepts, and walk through the journal entries and financial implications for Wintergreen, Incorporated.

Understanding Bond Issuance at a Discount

When Wintergreen, Incorporated, issues bonds, it is essentially borrowing money from investors with the promise to pay back the principal amount at maturity along with periodic interest payments. The key details in this scenario are:

- Face (par) value of bonds: \$150,000
- Coupon (stated) interest rate: 7%
- Term: 10 years
- Cash received (issue price): \$139,875

Notice that the bonds are issued for less than their face value (\$150,000), which indicates that they are issued at a discount. The difference between face value and issuance proceeds is considered a discount on bonds payable.

Why Do Bonds Sell at a Discount?

Bonds typically sell at a discount when the coupon rate (7%) is below the prevailing market interest rate for similar bonds. Investors require a higher yield than the coupon rate to compensate for the lower periodic interest payments, so they purchase the bonds at a discount to achieve a higher effective interest rate.

Key Components of the Bond Transaction

1. Face Value and Coupon Payments

- The bonds' face value: \$150,000
- Annual coupon payment: 7% of \$150,000 = \$10,500

2. Issue Price and Discount

- Issue price: \$139,875
- Discount on bonds payable: $\$150,000 - \$139,875 = \$10,125$

3. Term and Interest Payments

- Term: 10 years
- Payments: Typically, bonds pay interest semiannually or annually. For simplicity, assume annual payments unless specified otherwise.

Financial and Accounting Implications

Issuing bonds at a discount impacts several financial statement elements:

- Liability Recognition: Bonds payable are recorded at their carrying amount (initial amount received plus amortized discount).
- Interest Expense: The actual interest expense recognized over the life of the bonds will be greater than the coupon payments because of the amortization of the discount.
- Effective Interest Method: The amortization of the discount is usually calculated using the effective interest method, which allocates interest expense based on the bond's carrying amount and market rate at issuance.

Step-by-Step Analysis

Step 1: Recording the Bond Issue

At issuance, Wintergreen records the bonds payable at the proceeds received:

Journal Entry on December 31:

- Debit Cash for \$139,875
- Debit Discount on Bonds Payable for \$10,125
- Credit Bonds Payable for \$150,000

This reflects the obligation to pay the face value at maturity, with the discount amortized over time.

Step 2: Recognizing Interest Expense and Amortization

Assuming annual interest payments and the use of the effective interest method, the interest expense for each period is calculated as:

$\text{Interest Expense} = \text{Carrying Amount at Beginning of Period} \times \text{Market Rate (effective rate)}$

Since the bonds are issued at a discount, the effective rate is higher than the coupon rate.

Approximate calculation:

- The initial carrying amount: \$139,875
- The stated coupon interest (cash payment): \$10,500

The effective interest rate can be approximated using financial calculator or software; for illustration, assume it is around 8%.

Interest Expense for Year 1:

- $\$139,875 \times 8\% = \text{approximately } \$11,190$

Amortization of Discount:

- $\$11,190 \text{ (interest expense)} - \$10,500 \text{ (cash interest)} = \690

This amortization increases the carrying amount of the bonds payable:

- New carrying amount after Year 1: $\$139,875 + \$690 = \$140,565$

Repeat this process annually for the 10-year term, amortizing the discount gradually until the carrying amount reaches the face value of \$150,000 at maturity.

Step 3: Financial Statement Impact

- Balance Sheet:

- Bonds payable are reported at amortized cost, increasing over time as the discount is amortized.
- The discount on bonds payable is a contra-liability account that reduces the bonds payable initially recorded.

- Income Statement:

- The interest expense recognized each period reflects the market rate, which is higher than the coupon rate.
- Over time, interest expense increases as the discount amortizes.

Important Concepts in Bond Accounting

1. Amortization of Discount

The amortization process spreads the bond discount over the bond's life, increasing interest expense gradually and bringing the book value of bonds payable up to the face value at maturity.

2. Effective Interest Method vs. Straight-Line Method

- The effective interest method is the preferred approach, as it provides a more accurate reflection of interest expense over time.
- The straight-line method simplifies calculations but is less accurate and may not comply with generally accepted accounting principles (GAAP).

3. Bond Premium vs. Discount

- Bonds issued above face value are issued at a premium.
- Bonds issued below face value are issued at a discount.
- Both premiums and discounts are amortized over the bond's life.

Financial Ratios and Investor Perspective

Issuing bonds at a discount affects key financial ratios:

- Debt-to-Equity Ratio: Increases due to the higher book value of liabilities.
- Interest Coverage Ratio: May be impacted because interest expense is higher than cash interest payments.
- Effective Yield: Investors receive a higher yield than the coupon rate due to the discount.

From an investor's perspective, bonds issued at a discount are attractive if they seek higher yields, but the issuing company bears higher interest expenses over the term.

Practical Example: Journal Entries for the First Year

At issuance (December 31):

Account	Debit	Credit
Cash	\$139,875	
Discount on Bonds Payable	\$10,125	
Bonds Payable		\$150,000

At year-end (assuming \$11,190 interest expense and \$10,500 cash interest):

Account	Debit	Credit
Interest Expense	\$11,190	
Discount on Bonds Payable	\$690	
Cash		\$10,500

This pattern repeats annually, with the discount amortization increasing the bond's carrying amount.

Final Maturity and Amortization Schedule

Over the 10-year term, the discount will be fully amortized:

- Bonds payable will reach \$150,000
- Total interest expense over the life will be higher than total cash paid (\$105,000), reflecting the amortized discount

Key Takeaways:

- Bonds issued at a discount reflect market conditions and the company's creditworthiness.
- Proper amortization ensures accurate financial reporting.
- Understanding bond accounting helps in analyzing a company's leverage and cost of debt.

Conclusion

The issuance of \$150,000 of 7 percent, 10-year bonds at a cash price of \$139,875 by Wintergreen, Incorporated, is a textbook example of bond issuance at a discount. This transaction not only provides necessary capital but also influences the company's financial statements, interest expense, and ratios. Recognizing the nuances of bond accounting—such as discount amortization, effective interest calculations, and reporting—enables investors, analysts, and accountants to interpret the company's financial health accurately.

By comprehending these principles, stakeholders can better evaluate the cost of debt, the company's leverage position, and the overall impact of bond financing on corporate financial strategy.

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