1. Answer: B – Issuing a long-term note will increase current, not long-term assets. The long-term liability, notes payable, will increase as well. The cash inflow is a financing, not an investing, activity.
2. Answer: D – When each payment is made on an installment note, the current asset cash decreases. Interest expense is also recognized for the portion of the payment that is interest, and the long-term liability notes payable decreases. The part of the payment that is interest is a cash outflow for operating activities and the part that reduces principle is a cash outflow for financing activities.
3. Answer: D – Making a payment on a long-term serial note and repaying a bond will both cause long-term liabilities to decrease. Accounts payable is a current, not long-term liability.
4. Answer: C - $50,000 x .06 = $3,000 interest expense in 2015; $11,870 payment - $3,000 interest = $8,870 principle reduction in 2015; $50,000 - $8,870 = $41,130 principle balance at the beginning of 2016; $41,130 x .06 = $2,467.80 interest expense in 2016.
5. Answer: B - $50,000 x .06 = $3,000 interest expense in 2015; $11,870 payment - $3,000 interest = $8,870 principle reduction in 2015; $50,000 - $8,870 = $41,130 principle balance at the beginning of 2016; $41,130 x .06 = $2,467.80 interest expense in 2016; $11,870 - $2,467.80 = $9,402.20 principle reduction in 2015; $41,130 - $9,402.20 = $31,727.80 principle balance at the end of 2016.
6. Answer: D – When bonds are issued at face value, the interest expense and the carrying value remain constant from year to year. The last annual payment on a bond does not pay off the bond. The principle must still be repaid in its entirety upon maturity.
7. Answer: C – When a company issues bonds at face value, current assets (cash) and long-term liabilities (notes payable) both increase equally. No expense is recognized until the first interest payment is made.
8. Answer: A – The interest payment on a bond issued at face value will be reported as a cash outflow for operating activities on the statement of cash flows since it is entirely interest expense.
9. Answer: A – Bonds are issued at a discount when the market rate of interest is greater than the stated rate on the bonds. Discounting the bonds will create an effective rate of interest equal to the market rate.
10. Answer: B – If bonds are issued at a discount, the carrying value of the bonds will increase over time as the discount on the bonds decreases.
11. Answer: D – All of these are true. If bonds are issued at a premium, the market rate of interest must have been lower than the stated rate. The carrying value of the bonds will decrease over time as the premium on the bonds decreases. As each interest payment is made, the amortization of the bond premium will cause the interest expense to be lower than the interest payment.
12. Answer: A – If $200,000 of bonds are issued for 102, it means that the bonds are issued for 102% of face value, or $204,000.
13. Answer: B – If a bond discount is amortized using the effective interest method, interest expense will increase each year as the carrying value of the bonds increases.
14. Answer: D – If bonds are issued at 104, it means that the bonds are issued at 104% of face value, or at a premium. Bonds are issued at a premium if the stated rate of the bonds is greater than the market rate. As the bond premium is amortized, interest expense will be lower than the interest payment.
15. Answer: C – Callable bonds are bonds that can be redeemed early at the option of the bond issuer, not the bondholder.
16. Answer: C – If $100,000 of bonds are called at a price of 102, the bond issuer must pay bondholders 102% of the face value, or $102,000. Long term liabilities will decrease by $100,000 and the issuer will record a loss on bond redemption of $2,000, which will decrease net income by $2,000.
17. Answer: D – When a bond discount is amortized, the contra-liability account “discount on bonds payable” decreases, causing long-term liabilities to increase. The amortization also increases interest expense, which in turn decreases equity.
18. Answer: A – Redeeming a bond issued at face value on its maturity date will decrease current assets (cash) and decrease long-term liabilities (bonds payable). It is a cash outflow for financing activities. If the bonds had been called at 102, there would have been a loss recorded. A payment on an installment note would also have involved interest expense and part of the cash flow would have been for operating activities.
19. Answer: B – When a bond premium is amortized, the premium account decreases, which decreases the carrying value of the bond. However, the bonds payable account itself is unaffected.
20. Answer: B – The total amount of interest expense recognized over the life of the bond will be equal to 6% x $200,000 x 10 years, or $120,000, plus the amount of the discount, $2% x $200,000 = $4,000, for a total of $124,000.