FAR
Financial Accounting & Reporting
Roger Philipp, CPA
## Far

**Table of Contents**

### FAR-1

**Introduction**

- 1

**FAR-1**

- **Conceptual Framework**
  
- 2

- **Cash & Cash Equivalents, Balance Sheet**
  
- 3

- **Cost & Equity Method**
  
- 4

- **Marketable Securities**
  
- 5

- **Financial Instruments & Derivatives**
  
- 6

### FAR-2

- **Inventory**
  
- 7

- **Property, Plant & Equipment (Fixed assets)**
  
- 8

- **Intangible Assets, R&D Costs & Other Assets**
  
- 9

### FAR-3

- **Bonds**
  
- 10

- **Leases**
  
- 11

- **Liabilities**
  
- 12

- **Receivables**
  
- 13

### FAR-4

- **Pensions & Postemployment Benefits**
  
- 14

- **Stockholders’ Equity**
  
- 15

- **Partnerships**
  
- 16
Bonds

The following is an excerpt from the Roger CPA Review Textbooks, which are included with purchase of the Roger CPA Review course. Written and updated by your instructor, Roger Philipp, CPA, the textbooks are the perfect companion to our dynamic lectures.
Bonds

A bond is a borrowing agreement in which the issuer promises to repay a certain amount of money (Face/Par value) to the purchaser, after a certain period of time (term), at a certain interest rate (Effective, Yield, Market rate). This is covered by APB #21 (ASC 470/835).

- **Term bond** - A bond that will pay the entire principal upon maturity at the end of the term.
- **Serial bond** - A bond in which the principal matures in installments.
- **Debenture bonds** - Unsecured bonds that are not supported by any collateral.
- **Stated, face, coupon, nominal rate** - The rate printed on the bond. Represents the amount of cash the investor will receive every payment.
- **Carrying amount** - This is the net amount at which the bond is being reported on the balance sheet, and equals the face value of the bond plus the **premium** (when the bond was issued above face value) or minus the **discount** (when the bond was issued below face value). It is also called the book value or reported amount. It will initially be the same as issue price, but gradually approaches the face value as time passes, since the premium or discount is amortized over the life of the bond.
- **Effective rate, Yield, Market Interest rate** - This is the actual rate of interest the company is paying on the bond based on the issue price. When the bond is issued at a **premium**, the effective rate of interest will be lower than the stated rate, since the cash interest and principal repayment are based on face value, but the company actually received more money than that. When the bond is issued at a **discount**, the effective rate of interest will be higher than the stated rate, since the company must pay cash interest and principal based on a higher amount than the funds actually received upon issuance. The effective rate is often called the market rate of interest or yield.
- **Callable bond** - A bond which the issuer has the right to redeem prior to its maturity date.
- **Covenants** - Restrictions that borrowers must often agree to.

SFAS 159 provides that a company may elect the fair value option for reporting financial assets and financial liabilities. If the fair value option is elected for a financial liability (bonds), the requirements of APB 21 no longer apply. Instead, the financial liability is reported at fair value at the end of each reporting period, and the resulting gain or loss is reported in earnings of the period.

If an entity does not elect the fair value option, the bond is recorded at its issue price, and the effective interest method is used to amortize any premium or discount on the bond. The remainder of this section will focus on the pricing of the bond using the effective interest method of amortizing a bond as required by APB 21.

**Issuance of bonds (example)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Face value of bonds</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Term</td>
<td>5 years</td>
</tr>
<tr>
<td>Stated interest rate</td>
<td>8%</td>
</tr>
<tr>
<td>Effective rate/Market rate/Yield</td>
<td>a) 8%, b) 10%, c) 6% (3 examples)</td>
</tr>
</tbody>
</table>
a) Bond issued at **Par value** where market rate of interest (8%) equals the stated rate (8%).

\[
\begin{align*}
\text{Cash} & \quad 1,000,000 \\
\text{Bonds Payable} & \quad 1,000,000 \\
\end{align*}
\]

Each year interest will be received for \(1,000,000 \times 8\%\) (stated rate) = $80,000 per year

\[
\begin{align*}
\text{Interest expense} & \quad 80,000 \\
\text{Cash} & \quad 80,000 \\
\end{align*}
\]

b) Bond issued at a discount, since the stated rate of 8% is lower than the market rate of 10%, the only reason you would purchase this bond is if you would effectively yield 10%. In order to do so, the issuer must sell the bond at a **DISCOUNT** (the actual cash proceeds must be precisely computed using present value factors and are only estimated in this journal entry).

\[
\begin{align*}
\text{Cash} & \quad 900,000 \\
\text{Discount} & \quad 100,000 \\
\text{Bonds Payable} & \quad 1,000,000 \\
\end{align*}
\]

The **discount must be amortized** over the life of the bond. Let's assume we are using straight-line amortization of $20,000 year \((100/5\text{yrs}=20)\).

\[
\begin{align*}
\text{Interest expense} & \quad 100,000 \\
\text{Discount} & \quad 20,000 \\
\text{Cash} & \quad 80,000 \\
\end{align*}
\]

c) Bond issued for a premium, since the stated rate of 8% is higher than the Market rate of 6%. We are paying a **PREMIUM** to acquire this bond (the actual cash proceeds must be precisely computed using present value factors and are only estimated in this journal entry).

\[
\begin{align*}
\text{Cash} & \quad 1,100,000 \\
\text{Premium} & \quad 100,000 \\
\text{Bonds Payable} & \quad 1,000,000 \\
\end{align*}
\]

The premium must be amortized over the life of the bond. \((100/5=20)\)

\[
\begin{align*}
\text{Interest expense} & \quad 60,000 \\
\text{Premium} & \quad 20,000 \\
\text{Cash} & \quad 80,000 \\
\end{align*}
\]
The next consideration is how to calculate the proceeds from the issuance of the bonds. The above examples assumed the proceeds were given at 900,000 to 1,100,000. To calculate the **Present Value of the proceeds** two amounts need to be P.V.

- **PV of the Face** of the bonds (Face x P.V. of a lump sum using the Effective interest rate)
- **PV of the interest** as an annuity (Face x stated rate x time = interest x PV of an Ordinary annuity at the effective interest rate)
  - The sum of these two amounts represents the PV of the bonds.
  - If semi-annual interest is being paid, take the years x 2 and the interest rate/2
    - Ex. 5 yr bonds at 10% semi-annual. Use the PV table for 10 periods @ 5%.

In some circumstances, a problem will not require the use of present value to calculate the proceeds from issuance. It may instead express the sales price of the bond in terms of a percentage of face value.

- When bonds are issued at 101, for example, the proceeds would be 101% of face value.
- If they are issued at 98, the proceeds would be 98% of face value.

**Present Value Tables - Time Value of Money** (ASC 835)

To determine the exact selling price of a bond requires the use of present value concepts. Money that is received at a future date is less valuable than money received immediately, and present value concepts relate future cash flows to the equivalent present dollars. Many decisions require adjustments related to the time value of money:

- **Present Value of Amount (lump sum)** – This is used to examine a single cash flow that will occur at a future date and determine its equivalent value today.

- **Present Value of Ordinary Annuity** – This refers to repeated cash flows on a systematic basis, with amounts being paid at the end of each period (it may also be known as an **annuity in arrears**). Bond interest payments are commonly made at the end of each period and use these factors.

- **Present Value of Annuity Due (Now)** – This refers to repeated cash flows on a systematic basis, with amounts being paid at the beginning of each period (it may also be known as an **annuity in advance** or special annuity). Rent payments are commonly made at the beginning of each period and use these factors.
  - The present value of an annuity due factor can be found by multiplying the present value of an ordinary annuity factor by 1 plus the interest rate. P.V. of ordinary annuity of 1 @ 10% for 2 periods = 1.736. P.V of an annuity due of 1 at 10% for 3 periods = 2.736 (1.736 + 1)

- **Future Values** – These look at cash flows and project them to some future date, and include all three variations applicable to present values. This is the amount that would accumulate at a future point in time if $1 were invested now (compound interest). The future value factor is equal to 1 divided by the present value factor. For example, an investment of $10,000 in two years at 10% would accumulate to the principal multiplied by the future value factor. In this case the $10,000 × 1/0.8265 = $12,100.

**Actual factors for $1 are typically provided in tables to be multiplied by the cash flows in exam problems.**

As an example, assume that a company can earn 10% on its money. If it had to wait one year to receive a dollar, that would be the equivalent to them of 91 cents today (rounding all information to the nearest penny). The reason is that 91 cents invested at 10% would earn approximately 9
cents over the next year, and become a dollar. The way this relationship is expressed is by saying that the present value of 1 at 10% for 1 period = 0.91.

For multiple years at 10%, the factors are:

<table>
<thead>
<tr>
<th>Years</th>
<th>Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.91</td>
</tr>
<tr>
<td>2</td>
<td>0.83</td>
</tr>
<tr>
<td>3</td>
<td>0.75</td>
</tr>
<tr>
<td>4</td>
<td>0.68</td>
</tr>
<tr>
<td>5</td>
<td>0.62</td>
</tr>
</tbody>
</table>

**Ordinary Annuity** 3.79

An ordinary annuity refers to payments being made at the end of each period, and is simply the sum of the value of each of the payments. In the above, the present value of an ordinary annuity of 1 at 10% for 5 periods = 3.79, meaning that getting one dollar each year for the next 5 years is the equivalent of getting $3.79 immediately. Another way to express it is to say that a person who paid $3.79 today to obtain an annuity of $1 per year for the next 5 years is earning a 10% rate of return on their investment.

Assume the following facts on the issuance of a single bond:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Face Value</strong></td>
<td>$1,000</td>
</tr>
<tr>
<td><strong>Stated Rate</strong></td>
<td>8%</td>
</tr>
<tr>
<td><strong>Effective Rate</strong></td>
<td>10%</td>
</tr>
<tr>
<td><strong>Issue Date</strong></td>
<td>1/1/X1</td>
</tr>
<tr>
<td><strong>Pay Dates for Interest</strong></td>
<td>12/31</td>
</tr>
<tr>
<td><strong>Due Date for Principal</strong></td>
<td>12/31/X5</td>
</tr>
<tr>
<td><strong>PV of 1 at 10% for 5 periods</strong></td>
<td>0.62</td>
</tr>
<tr>
<td><strong>PV of ordinary annuity at 10% for 5 periods</strong></td>
<td>3.79</td>
</tr>
</tbody>
</table>

To determine the selling price of this term bond on 1/1/X1, the interest payments of $1,000 x 8% = $80 per year and the principal payment of $1,000 due in 5 years will be discounted at the effective rate of return of 10%, as follows:
<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
<th>PV Factor</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal</td>
<td>$1,000</td>
<td>0.62</td>
<td>$620</td>
</tr>
<tr>
<td>Interest (Annuity)</td>
<td>$80</td>
<td>3.79</td>
<td>$304</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>$924</td>
</tr>
</tbody>
</table>

Notice that, as expected, the selling price of the bond is less than face value, because the effective rate of interest of 10% exceeds the stated rate of 8%.

The entry to record the issuance is as follows:

1/1/X1

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>924</td>
<td></td>
</tr>
<tr>
<td>Unamortized discount</td>
<td>76</td>
<td></td>
</tr>
<tr>
<td>Bond payable</td>
<td></td>
<td>1,000</td>
</tr>
</tbody>
</table>

Both the bond payable and unamortized discount are reported in noncurrent liabilities.

Occasionally, a company will issue a zero-coupon bond, which refers to a bond that pays no periodic interest (0% coupon rate of interest). The bondholder only receives the face value of the bond at maturity.

**JOURNAL ENTRY at issuance** (with BIC and Accrued Interest)

3. Cash [\% face + Accrued Interest – BIC]
4. BIC
5. Discount (plug)

1. Bond Payable (Face)
2. Accrued Interest Payable = [face x(stated rate)x(time – since last interest paid)]
5. Premium (plug)

**Note:** The carrying value (CV) of the bonds is Bonds Payable (1), net of the discount or premium (5), not net of BIC

**Accrued Interest Payable**

A bond isn’t always sold when it is dated. The 8% bond dated 1/1/X1 in our earlier example might, for example, not be issued to the public until 4/1/X1. Even so, interest accrues from the date on the bond, so the buyer is immediately credited for 3 months of interest ($1,000 x 8% x 3/12 of a year = $20), and will receive a full year of interest ($1,000 x 8% = $80) on 12/31/X1. To be equitable, the buyer will be required to pay an additional $20 on 4/1/X1 when purchasing the bond, and the issuer will report the amount as accrued interest payable, reported as a current liability. Assume, for this example, that the bond itself sells for 93. The entry to record the issuance on 4/1/X1 is:
The bond payable will be reported at $1,000 - $70 = $930. Notice that the reported amount refers to the carrying value of the bond, and is equal to the face value of the bond payable plus the unamortized premium or minus the unamortized discount. Accrued interest, like deferred bond issue costs, is not included in the carrying value of the bond.

**Bond Issue costs (BIC)** - Costs directly associated with the issuance of the bonds are a non-current asset and are amortized straight line over the period of time the bonds are outstanding.

- Printing and engraving of the bond certificates
- Legal and accounting fees
- Underwriter commissions
- Promotion costs (printing the prospectus)

For example, if a $10 sales commission was charged on the issuance of the bond in the previous example, the entry on the date of issuance would be:

**1/1/X1**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred bond issue costs</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Commissions payable</td>
<td></td>
<td>10</td>
</tr>
</tbody>
</table>

Over the life of the bonds, the costs are amortized onto the income statement. Although the effective interest method of amortization is theoretically preferred, let's look at straight-line amortization over the 5 years for the present example:

**12/31/X1**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bond issue expense</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Deferred bond issue costs</td>
<td></td>
<td>2</td>
</tr>
</tbody>
</table>

This same entry will be made at the end of each year. So long as the bond issue costs are not material in amount, it is acceptable to expense the costs entirely in the period the bonds are sold, or include them in determining the net issue price of the bonds. These alternative approaches are not, however, theoretically correct.

As mentioned earlier, the discount or premium may be amortized using the straight-line method (not GAAP), or the effective interest method (interest method). The Interest method is preferred and is GAAP.
Discount Amortization

<table>
<thead>
<tr>
<th>Face</th>
<th>- Discount = CV</th>
<th>Effective interest rate =</th>
<th>Interest expense (face x stated x time) =</th>
<th>Amortization Of Discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000,000 - 100,000 = 900,000 x 10%</td>
<td>90,000</td>
<td>10%</td>
<td>80,000</td>
<td>10,000</td>
</tr>
<tr>
<td>- 10,000</td>
<td>+10,000</td>
<td>1,000,000 - 90,000 = 910,000 x 10%</td>
<td>91,000</td>
<td>80,000</td>
</tr>
<tr>
<td>- 11,000</td>
<td>+11,000</td>
<td>1,000,000 - 79,000 = 921,000 x 10%</td>
<td>921,000</td>
<td>80,000</td>
</tr>
</tbody>
</table>

JE 1) Interest expense 90,000 Discount 10,000 JE 2) Interest expense 91,000 Discount 11,000
Cash 80,000

Note: When amortizing a discount, the interest expense increases each year, and the amortization of the discount increases each year.

Premium Amortization

<table>
<thead>
<tr>
<th>Face</th>
<th>+ Premium = CV</th>
<th>Effective interest rate =</th>
<th>Interest expense (face x stated x time) =</th>
<th>Amortization Of Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000,000 + 100,000 = $1,100,000 X 6%</td>
<td>66,000</td>
<td>6%</td>
<td>80,000</td>
<td>14,000</td>
</tr>
<tr>
<td>- 14,000</td>
<td>-14,000</td>
<td>1,000,000 + 86,000 = 1,086,000 X 6%</td>
<td>65,000</td>
<td>80,000</td>
</tr>
<tr>
<td>- 15,000</td>
<td>-15,000</td>
<td>1,000,000 + 71,000 = 1,071,000 X 6%</td>
<td>1,071,000</td>
<td></td>
</tr>
</tbody>
</table>

JE 1) Interest expense 66,000 Premium 14,000 JE 2) Interest expense 65,000 Premium 15,000
Cash 80,000

Note: when amortizing a premium, the interest expense decreases each year, but the amortization of the premium increases each year.

Bond Retirement

Bonds may be called or retired prior to maturity. When this happens, it is reported as a gain/loss on the income statement. Pursuant to SFAS #145, it will be classified as part of continuing operations, unless it is determined to be both unusual and infrequent, in which case it will be reported in extraordinary items, net of taxes. The journal entry is basically the opposite of the original issuance. The plug to balance the entry is Gain/Loss.
**Bond sinking funds**
A fund set up for the retirement of bonds. The balance is treated as a noncurrent asset until the bonds mature. Any interest or dividends earned are added to the sinking fund balance and reported as income.

**Convertible bonds (1 security)**
Convertible bonds give the bondholder the option of converting the bond into common stock. Since the bondholder cannot retain the bond and buy the stock, convertible bonds are treated as issuing a single security, so no value is given to the convertibility feature.

There are two ways of converting, Book Value method (GAAP), and the Market Value method (non-GAAP).

**Book Value method (no gain/loss)**
- Bonds Payable (face) X
- Premium X
- BIC X
- Common Stock (par value) X
- **Additional Paid-in capital** (plug) X

**Market Value method (gain/loss – not extraordinary)**
- Bonds Payable (face) X
- Premium X
- **Loss (or) (plug)** X
- BIC X
- Common Stock (par) X
- APIC X
- Gain (plug) X

**Note:** Under the book value method, all the accounts for the remaining balances are eliminated; credit Common Stock for Par value, and the plug is APIC. Under the Market value method, Common stock + APIC should be the FMV of the stock issued, the plug is a gain or loss. This gain/loss is **NOT extraordinary** since it is at the request of the bondholder.
**Bonds with Detachable Stock Purchase Warrants (2 securities)**

A warrant is a security that can be sold or exercised by the bondholder, while still keeping the bond. Since it is separable, it is as if two securities were issued, therefore a value must be given to both securities. The value for the Warrant is included in APIC.

- If the FMV of both securities is known, the **relative FMV approach** is used.
- If the FMV of only one security is known, the other is a Plug.
- The amount for warrants is recorded in APIC-Warrants.
- If Non-detachable stock purchase warrants, no separate value is given.

Ex: $800 par value of bonds with warrants is issued for $900. The relative FMV of bonds to warrants is 80% bonds, 20% warrants.

<table>
<thead>
<tr>
<th>Bonds with Warrants</th>
<th>80%</th>
<th>20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>-FMV of Bond WITHOUT warrant</td>
<td>X</td>
<td>80%</td>
</tr>
<tr>
<td>-FMV of Warrants</td>
<td>X</td>
<td>20%</td>
</tr>
<tr>
<td>Total FMV</td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash</th>
<th>proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bond 80% * 900 = 720</td>
<td></td>
</tr>
<tr>
<td>Warrant 20% * 900 = 180</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>900</td>
</tr>
</tbody>
</table>

\[ \text{Cash} \quad 900 \quad \text{Discount} \quad 80 \quad \text{Bond Payable} \quad 800 \quad \text{APIC – Warrants} \quad 180 \quad 720 \]

**Disclosures** should be made regarding the combined aggregate amount of maturities and sinking fund requirements for all long-term-borrowings for each of the **next 5 years**.
CLASS QUESTIONS

1. Hancock Co.'s December 31, 2003 balance sheet contained the following items in the long-term liabilities section:

   **Unsecured**
   - 9.375% registered bonds ($25,000 maturing annually beginning in 2007) $275,000
   - 11.5% convertible bonds, callable beginning in 2011, due 2023 $125,000

   **Secured**
   - 9.875% guaranty security bonds, due 2023 $275,000
   - 10.0% commodity backed bonds
     - ($50,000 maturing annually beginning in 2008) $200,000

What are the total amounts of serial bonds and debenture bonds?

<table>
<thead>
<tr>
<th>Serial bonds</th>
<th>Debenture bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $ 475,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>b. $ 475,000</td>
<td>$125,000</td>
</tr>
<tr>
<td>c. $ 450,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>d. $ 200,000</td>
<td>$650,000</td>
</tr>
</tbody>
</table>

2. On June 30, 20X3, King Co. had outstanding 9%, $5,000,000 face value bonds maturing on June 30, 20X8. Interest was payable semiannually every June 30 and December 31. On June 30, 20X3, after amortization was recorded for the period, the unamortized bond premium and bond issue costs were $30,000 and $50,000 respectively. On that date, King acquired all its outstanding bonds on the open market at 98 and retired them. At June 30, 20X3, what amount should King recognize as gain before income taxes on redemption of bonds?

   a. $ 20,000  
   b. $ 80,000  
   c. $120,000  
   d. $180,000

3. The following information pertains to Camp Corp.'s issuance of bonds on July 1, 20X3:

   - Face amount $800,000
   - Term Ten years
   - Stated interest rate 6%
   - Interest payment dates Annually on July 1
   - Yield 9%

<table>
<thead>
<tr>
<th>Present value of one for ten periods</th>
<th>At 6%</th>
<th>At 9%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Future value of one for ten periods</td>
<td>0.558</td>
<td>0.422</td>
</tr>
<tr>
<td>Present value of ordinary annuity of one for ten periods</td>
<td>1.791</td>
<td>2.367</td>
</tr>
<tr>
<td>Present value of ordinary annuity of one for ten periods</td>
<td>7.360</td>
<td>6.418</td>
</tr>
</tbody>
</table>

What should be the issue price for each $1,000 bond?

   a. $1,000  
   b. $ 864  
   c. $ 807  
   d. $ 700
4. On July 1, 20X3, after recording interest and amortization, York Co. converted $1,000,000 of its 12% convertible bonds into 50,000 shares of $1 par value common stock. On the conversion date the carrying amount of the bonds was $1,300,000, the market value of the bonds was $1,400,000, and York’s common stock was publicly trading at $30 per share. Using the book value method, what amount of additional paid-in capital should York record as a result of the conversion?

   a. $ 950,000  
   b. $1,250,000  
   c. $1,450,000  
   d. $1,500,000

5. On December 30, 20X3, Fort, Inc. issued 1,000 of its 8%, ten-year, $1,000 face value bonds with detachable stock warrants at par. Each bond carried a detachable warrant for one share of Fort’s common stock at a specified option price of $25 per share. Immediately after issuance, the market value of the bonds without the warrants was $1,080,000 and the market value of the warrants was $120,000. In its December 31, 20X3 balance sheet, what amount should Fort report as bonds payable?

   a. $1,000,000  
   b. $ 975,000  
   c. $ 900,000  
   d. $ 880,000
SOLUTIONS

1. (a) Serial bonds are bond issues that mature in installments (usually on the same date each year over a period of years). In this case, serial bonds total $475,000 ($275,000 + $200,000). Debenture bonds are bonds that are not secured by specifically designated collateral, but rather by the general assets of the corporation. The unsecured bonds total $400,000 ($275,000 + $125,000).

2. (b) A gain or loss on redemption of bonds is the difference between the cash paid ($5,000,000 x 98% = $4,900,000) and the net book value of the bonds. To compute the net book value, premium or discount and bond issue costs must be considered. Book value is $4,980,000 ($5,000,000 face value, less $50,000 bond issue costs, plus $30,000 premium). Therefore the gain or redemption is $80,000 ($4,980,000 book value less $4,900,000 cash paid).

<table>
<thead>
<tr>
<th>Bonds Payable</th>
<th>5,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium</td>
<td>30,000</td>
</tr>
<tr>
<td>Bond Issue costs</td>
<td>50,000</td>
</tr>
<tr>
<td>Cash</td>
<td>4,900,000 (5,000,000 x .98)</td>
</tr>
<tr>
<td>Gain</td>
<td>80,000</td>
</tr>
</tbody>
</table>

3. (c) The issue price of each bond is equal to the present value (PV) of the maturity value plus the PV of the interest annuity. The PV must be computed using the yield rate (9%). The computation is

<table>
<thead>
<tr>
<th>Amount</th>
<th>PV factor</th>
<th>PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000</td>
<td>.422</td>
<td>$422</td>
</tr>
<tr>
<td>60</td>
<td>6.418</td>
<td>385</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$807</td>
</tr>
</tbody>
</table>

The annuity interest amount above ($60) is the principal ($1,000) times the stated cash rate (6%).

4. (b) Using the book value method, the common stock is recorded at the carrying amount of the converted bonds, less any conversion expenses. Since there are no conversion expenses in this case, the common stock is recorded at the $1,300,000 carrying amount of the converted bonds. The par value of the stock issued is $50,000 (50,000 x $1), so additional paid-in capital (APIC) of $1,250,000 ($1,300,000 – $50,000) is recorded. The entry is

- Bonds payable 1,000,000
- Premium on B.P. 300,000
- Common stock 50,000
- APIC 1,250,000

Note that when the book value method is used, FMV are not considered, and no gain or loss is recognized.

5. (c) APB 14 states that the proceeds of bonds issued with detachable warrants are allocated between the bonds and the warrants based upon their relative FMV at the time of issuance. In this case, the portion allocated to the bonds is $900,000, calculated as follows:

\[ \frac{1,080,000}{1,080,000 + 120,000} = 90\%; \quad 90\% \times 1,000,000 = 900,000 \]

Therefore, the bonds payable are reported at $900,000 (face value $1,000,000 less discount $100,000).
Simulation #1

On January 2, 20X3, North Co. issued bonds payable with a face value of $480,000 at a discount for $360,000 cash. The bonds are due in ten years and interest is payable semiannually every June 30 and December 31. On June 30, 20X3, and on December 31, 20X3, North made the semiannual interest payment of $14,400 when due, recorded interest expense of $18,000 on the first interest payment, and recorded the appropriate amortization of bond discount.

Complete Items 1 through 14 in the amortization table below by selecting the correct amounts from the menu given. A response may be selected once, more than once, or not at all.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash</th>
<th>Interest expense</th>
<th>Amortization</th>
<th>Discount</th>
<th>Carrying amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/2/03</td>
<td></td>
<td></td>
<td></td>
<td>(1)</td>
<td>(2)</td>
</tr>
<tr>
<td>6/30/03</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
<td>(6)</td>
<td>(7)</td>
</tr>
<tr>
<td>12/31/03</td>
<td>(8)</td>
<td>(9)</td>
<td>(10)</td>
<td>(11)</td>
<td>(12)</td>
</tr>
</tbody>
</table>

Annual Interest Rates:

- Stated rate (13)
- Effective rate (14)

<table>
<thead>
<tr>
<th>Rates</th>
<th>Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. 3.0%</td>
<td>G. $3,420</td>
</tr>
<tr>
<td>B. 4.5%</td>
<td>H. $3,600</td>
</tr>
<tr>
<td>C. 5.0%</td>
<td>I. $3,780</td>
</tr>
<tr>
<td>D. 6.0%</td>
<td>J. $3,960</td>
</tr>
<tr>
<td>E. 9.0%</td>
<td>K. $10,908</td>
</tr>
<tr>
<td>F. 10.0%</td>
<td>L. $11,016</td>
</tr>
<tr>
<td></td>
<td>M. $14,400</td>
</tr>
<tr>
<td></td>
<td>N. $17,820</td>
</tr>
<tr>
<td></td>
<td>O. $18,000</td>
</tr>
</tbody>
</table>
Simulation #2

On January 2, 2007, Parker Co. issued 6% bonds with a face value of $400,000 when the market interest rate was 8%. The bonds are due in ten years, and interest is payable every June 30 and December 31. Parker does not elect the fair value option for reporting its financial liabilities.

Parker Co. $50 par value common stock has always traded above par. During 2007, Parker had several transactions that affected the following balance sheet accounts:

I. Bond discounts
II. Bond premium
III. Bond payable
IV. Common stock
V. Additional paid-in capital
VI. Retained earnings

For each of the following items, determine whether the transaction Increased, Decreased, or had No effect for each of the items in the chart.

1. Parker issued bonds payable with a nominal interest rate that was less than the market rate of interest.
2. Parker issued convertible bonds, which are common stock equivalents, for an amount in excess of the bonds’ face amount.
3. Parker issued common stock when the convertible bonds described in item 2 were submitted for conversion. Each $1,000 bond was converted into twenty common shares. The book value method was used for the early conversion.
4. Parker issued bonds with nondetachable warrants for an amount equal to the face amount of the bonds. The stock warrants do not have a determinable value.
5. Parker issued bonds, with detachable stock warrants, for an amount equal to the face amount of the bonds. The stock warrants have a determinable value.
6. Parker redeemed a bond issued at 8% at a discount for an amount that was 102% of face value.
7. Parker issued bonds payable with a nominal rate of interest that is higher than the market rate.
8. Parker called a bond that was issued at 105 at a time when the market value
of the bond was less than its carrying value.

<table>
<thead>
<tr>
<th>Situation</th>
<th>Concepts</th>
<th>Bond Valuation</th>
<th>Amortization Schedule</th>
<th>Journal Entries</th>
<th>Communication</th>
<th>Research</th>
</tr>
</thead>
</table>

Use the following present value and present value annuity tables to calculate the selling price of the bond on January 2, 2007. Round your final answer to the nearest dollar.

**Present Value Ordinary Annuity of $1**

<table>
<thead>
<tr>
<th>Periods</th>
<th>3%</th>
<th>4%</th>
<th>6%</th>
<th>8%</th>
<th>12%</th>
<th>16%</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 periods</td>
<td>4.5797</td>
<td>4.4518</td>
<td>4.2124</td>
<td>3.9927</td>
<td>3.6048</td>
<td>3.2743</td>
</tr>
<tr>
<td>10 periods</td>
<td>8.5302</td>
<td>8.1109</td>
<td>7.3601</td>
<td>6.7101</td>
<td>5.6502</td>
<td>4.8337</td>
</tr>
</tbody>
</table>

**Present Value of $1**

<table>
<thead>
<tr>
<th>Periods</th>
<th>3%</th>
<th>4%</th>
<th>6%</th>
<th>8%</th>
<th>12%</th>
<th>16%</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 periods</td>
<td>.8626</td>
<td>.8219</td>
<td>.7473</td>
<td>.6806</td>
<td>.5674</td>
<td>.4761</td>
</tr>
<tr>
<td>10 periods</td>
<td>.7441</td>
<td>.6756</td>
<td>.5584</td>
<td>.4632</td>
<td>.3220</td>
<td>.2267</td>
</tr>
<tr>
<td>20 periods</td>
<td>.5537</td>
<td>.4564</td>
<td>.3118</td>
<td>.2145</td>
<td>.1037</td>
<td>.0514</td>
</tr>
</tbody>
</table>

Selling price of the bond

<table>
<thead>
<tr>
<th>Situation</th>
<th>Concepts</th>
<th>Bond Valuation</th>
<th>Amortization Schedule</th>
<th>Journal Entries</th>
<th>Communication</th>
<th>Research</th>
</tr>
</thead>
</table>

Prepare the amortization schedule for the bond through December 31, 2007. Round all numbers to the nearest dollar.

<table>
<thead>
<tr>
<th>Date</th>
<th>Interest paid</th>
<th>Interest expense</th>
<th>Amortization of discount</th>
<th>Discount on bond payable</th>
<th>Carrying value of bond payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/2/07</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6/30/07</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/07</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


2. Prepare the journal entry for the interest payment on June 30, 2007.

On June 30, 2004, Parker Co. issued fifteen-year 12% bonds at a premium (effective yield 10%). On November 30, 2007, Parker transferred both cash and property to the bondholders to extinguish the entire debt. The fair value of the transferred property equaled its carrying amount. The fair value of the cash and property transferred exceeded the bonds’ carrying amount.

Write a memorandum to the finance manager of Parker that

1. Explains the purpose of the effective interest method and the effect of applying the method in 2004 on Parker’s bond premium.

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2. States the effect on 2004 interest expense, net income, and the carrying amount of the bonds if Parker had incorrectly adopted the straight-line interest method instead of the effective interest method.

3. Describes how Parker should calculate and report the effects of the November 30, 2007 transaction in its 2007 income statement. Why is this presentation appropriate? (Ignore income taxes.)

To: Finance Manager, Parker Co.
From: CPA Candidate
Re: Accounting for bonds

REMEMBER: Your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.

<table>
<thead>
<tr>
<th>Research</th>
</tr>
</thead>
<tbody>
<tr>
<td>Situation</td>
</tr>
</tbody>
</table>

Research the professional standards regarding guidance on the appropriate interest rate to use to discount a note payable with an unrealistic rate. Indicate the appropriate source in the box below.
Simulation Solution #1

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash</th>
<th>Interest expense</th>
<th>Amortization</th>
<th>Discount</th>
<th>Carrying amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/2/X3</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>$120,000</td>
<td>$360,000</td>
</tr>
<tr>
<td>6/30/X3</td>
<td>$14,400</td>
<td>$18,000</td>
<td>$3,600</td>
<td>$116,400</td>
<td>$363,600</td>
</tr>
<tr>
<td>12/31/X3</td>
<td>$14,400</td>
<td>$18,180</td>
<td>$3,780</td>
<td>$112,620</td>
<td>$367,380</td>
</tr>
</tbody>
</table>

Annual Interest Rates:  
Stated rate: 6.0%  
Effective rate: 10.0%

1. The discount on bonds is (face – carrying value). The carrying value is $360,000, the issue price. Therefore, the discount is $120,000 ($480,000 - $360,000).

2. The carrying amount at date of issue is the issue price, $360,000.

3. The cash interest payment is $14,400 and is given in the problem. Notice that this is calculated from the face value of the bond, which equals $480,000, and $14,400 / $480,000 = 3% for the 6-month period, indicating that the stated rate of interest on the bond is 6% per year.

4. The interest expense is $18,000 and is given in the problem. Notice that this is calculated from the carrying value of the bond as of the beginning of the period, $360,000, and $18,000 / $360,000 = 5% for the 6-month period, indicating that the effective rate of interest on the bond is 10% per year.

5. The discount is amortized by $3,600. The discount account approaches zero as the bond approaches maturity date. Therefore, the discount on 6/30/X3 is $116,400 ($120,000 - $3,600).

6. Amortization of discount is interest expense minus cash interest payment ($18,000 - $14,400) = $3,600.

7. The carrying amount of a bond issued at a discount rises and approaches the face value as the bond approaches maturity date. Therefore, the carrying amount on 6/30/X3 is $363,600 ($360,000 + $3,600).

8. The cash interest payment is the same as the previous 6-month period. It is always the face value x stated rate x ½ of a year, and since the stated rate and face value never change, neither does the payment, and it will be $14,400 ($480,000 face value x 6% stated rate by ½ of a year).

9. The interest expense for the 6-month period is the carrying value at the beginning of the period x effective rate x ½ of a year, which would be $363,600 x 10% x ½ = $18,180.

10. Amortization of discount is interest expense minus cash interest payment ($18,180 - $14,400) = $3,780.

11. The discount is amortized by $3,780, so the discount on 12/31/X3 is $116,400 - $3,780 = $112,620.

12. Carrying amount increases by the amortization for the period, and equals $363,600 + $3,780 = $367,380.

13. The stated rate of interest based on the cash interest payments of $14,400 on the $480,000 face value for each 6-month period is $14,400 / $480,000 x 2 = 6.0%.

14. The effective rate of interest based on the interest expense of $18,000 on the $360,000 initial carrying value for the first 6-month period is $18,000 / $360,000 x 2 = 10.0%.
## Simulation Solution #2

<table>
<thead>
<tr>
<th>Situation</th>
<th>Concepts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Bond Valuation</td>
</tr>
<tr>
<td>1. Parker issued bonds payable with a nominal interest rate that was less than the market rate of interest.</td>
<td>Increase</td>
</tr>
<tr>
<td>2. Parker issued convertible bonds, which are common stock equivalents, for an amount in excess of the bonds’ face amount.</td>
<td>No effect</td>
</tr>
<tr>
<td>3. Parker issued common stock when the convertible bonds described in item 2 were submitted for conversion. Each $1,000 bond was converted into twenty common shares. The book value method was used for the early conversion.</td>
<td>No effect</td>
</tr>
<tr>
<td>4. Parker issued bonds, with non-detachable warrants for an amount equal to the face amount of the bonds. The stock warrants do not have a determinable value.</td>
<td>No effect</td>
</tr>
<tr>
<td>5. Parker issued bonds, with detachable stock warrants, for an amount equal to the face amount of the bonds. The stock warrants have a determinable value.</td>
<td>Increase</td>
</tr>
<tr>
<td>6. Parker redeemed a bond issued at 8% at a discount for an amount that was 102% of face value.</td>
<td>Decrease</td>
</tr>
<tr>
<td>7. Parker issued bonds payable with a nominal rate of interest that is higher than the market rate.</td>
<td>No effect</td>
</tr>
<tr>
<td>8. Parker called a bond that was issued at 105 at a time when the market value of the bond was less than its carrying value.</td>
<td>No effect</td>
</tr>
</tbody>
</table>

### Explanation of solutions

1. Since the nominal rate of interest was less than the market rate of interest, the bonds sold at a discount. In other words, the investors paid less than the face value to acquire the bonds. The journal entry to record the transaction is

   \[
   \begin{align*}
   \text{Cash} & \quad xx \\
   \text{Discount on bonds payable} & \quad xx \\
   \text{Bonds payable} & \quad xx
   \end{align*}
   \]

   Therefore, the issuance of the bonds would increase both bonds payable and discount on bonds payable.

2. Per ASC Subtopic 470-20, convertible debt securities which may be converted into common stock at the option of the holder, and whose issue price is not significantly greater than face value, should be reported as debt upon issuance for the entire proceeds of the bonds. This reasoning is based on the inseparability of the debt and the conversion option, and the mutually exclusive options of the holder (i.e., holding either bonds or stock). The journal entry to record the transaction is

   \[
   \begin{align*}
   \text{Cash} & \quad xx \\
   \text{Premium on bonds payable} & \quad xx \\
   \text{Bonds payable} & \quad xx
   \end{align*}
   \]

   Therefore, the issuance of the convertible bonds would increase both bonds payable and premium on bonds payable.
3. When the book value method of accounting for the conversion of bonds into common stock is used, the common stock will be recorded at the book value of the bonds at the date of conversion. Thus, no gain or loss is recognized on the conversion. The journal entry to record the transaction is

Bonds payable xx
Premium on bonds payable xx
Common stock xx
Additional paid-in capital xx

Therefore, the conversion of the bonds would decrease bonds payable and premium on bonds payable while increasing common stock and additional paid-in capital.

4. Per ASC Subtopic 470-20, nondetachable warrants are not valued separately from the bond. Therefore, the entry to record the bond is

Cash xx
Bonds payable xx

5. ASC Subtopic 470-20 states that the proceeds of bonds issued with detachable warrants are allocated between the bonds and the warrants based upon their relative fair market values at the time of issuance. In this case, the bonds, with detachable stock warrants, were issued for an amount equal to the face amount of the bonds. Since part of the proceeds is allocated to the stock warrants, the bonds were issued at a discount. The journal entry to record the transaction is

Cash xx
Discount on bonds payable xx
Bonds payable xx
Additional paid-in capital—Stock warrants xx

Therefore, the issuance of the bonds, with detachable stock warrants, would increase bonds payable, discount on bonds payable, and additional paid-in-capital.

6. The bond was sold at a discount. Therefore, when the bond is redeemed, the bonds payable and the discount account must be removed from the records. The net carrying amount is less than the reacquisition price. Therefore, there is a loss on the extinguishment of debt. It will be an ordinary loss on the income statement. The journal entry for the transaction is

Bonds payable xx
Loss on bond xx
Discount on bond xx
Cash xx

7. Since the nominal rate of interest is greater than the market rate, the bonds sold at a premium. In other words, the investors paid more than face value for the bond. The journal entry to record the transaction is

Cash xx
Bonds payable xx
Premium on bond xx

8. The net carrying value is greater than the market value of the bond (reacquisition price). Therefore, there is a gain on the redemption of the bond. The journal entry for this transaction is

Premium on bonds payable xx
Bonds payable xx
Cash xx
Gain on extinguishment of debt xx

---

**Bond Valuation**

<table>
<thead>
<tr>
<th>Situation</th>
<th>Concepts</th>
<th>Valuation</th>
<th>Amortization Schedule</th>
<th>Journal Entries</th>
<th>Communication</th>
<th>Research</th>
</tr>
</thead>
<tbody>
<tr>
<td>PVA of $12,000 at 4% for 20 periods</td>
<td>+ PV of $400,000</td>
<td>(13.5903 × 12,000) + (.4564 × 400,000)</td>
<td>163,083.60 + 183,560</td>
<td>= 345,643.60</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>at 4% after 20 periods</td>
<td></td>
<td></td>
<td>Rounds to 345,644</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Amortization Schedule

<table>
<thead>
<tr>
<th>Date</th>
<th>Interest paid</th>
<th>Interest expense</th>
<th>Amortization of discount</th>
<th>Discount on bond payable</th>
<th>Carrying value of bond payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/2/09</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>54,356</td>
<td>345,644</td>
</tr>
<tr>
<td>6/30/09</td>
<td>12,000</td>
<td>13,826</td>
<td>1,826</td>
<td>52,530</td>
<td>347,470</td>
</tr>
<tr>
<td>12/31/09</td>
<td>12,000</td>
<td>13,899</td>
<td>1,899</td>
<td>50,631</td>
<td>349,369</td>
</tr>
</tbody>
</table>

1. The discount on bonds is (face – carrying value). The carrying value is $345,644, the issue price. Therefore, the discount account is $54,356 ($400,000 – $345,644).
2. The carrying amount at date of issue is the issue price, $345,644.
3. The cash interest payment is $12,000 and is given in the problem. This represents a semiannual interest rate of 3% ($400,000 × 3% = $12,000).
4. The interest expense is $13,826 ($345,644 × 4%) and is given in the problem.
5. Amortization of discount is interest expense minus cash interest payment ($12,000 – $13,826) = $1,826.
6. The discount is amortized by $1,826. The discount account approaches zero as the bond approaches maturity date. Therefore, the discount on 6/30/09 is $52,530 ($54,356 – $1,826).
7. The new carrying amount on 6/30/09 is $347,470 ($345,644 + $1,826).
8. The cash interest payment is the same as the previous period. It is always coupon interest rate times the face of the bond (3% × $400,000) = $12,000.
9. Interest expense is the carrying value times the effective rate. $13,899 = ($347,470 × 4%).
10. Amortization is the difference between the cash payment and the interest expense. $1,899 ($12,000 – $13,899).
11. Discount on bonds is $50,631 ($52,530 – $1,899).
12. Carrying amount is $349,369 ($347,470 + $1,899).

Journal Entries

<table>
<thead>
<tr>
<th>Situation</th>
<th>Concepts</th>
<th>Bond Valuation</th>
<th>Amortization Schedule</th>
<th>Journal Entries</th>
<th>Communication</th>
<th>Research</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. January 2, 2009</td>
<td>Cash</td>
<td>345,644</td>
<td>54,356</td>
<td>400,000</td>
<td>Cash</td>
<td>Discount on bonds payable</td>
</tr>
<tr>
<td>2. June 30, 2009</td>
<td>Interest expense</td>
<td>13,826</td>
<td>12,000</td>
<td>1,826</td>
<td>Cash</td>
<td>Discount on bonds payable</td>
</tr>
</tbody>
</table>

To: Finance Manager, Parker Co.
From: CPA Candidate
Re: Accounting for bonds

I have researched your issues regarding accounting for bonds. This memorandum provides explanations to your questions relating to the amortization and financial statement disclosures for bonds.

The purpose of the effective interest method is to provide periodic interest expense based on a constant rate over the life of the bonds. The impact of applying the effective interest method on Parker’s bond premium in 2006 is to decrease the premium by a lesser amount as compared to using the straight-line method of amortization.

Under the straight-line interest method, the premium is amortized at a constant periodic amount, and in 2006 the premium amortization would have been greater than amortization under the effective interest method. Consequently, for 2006, interest expense would have been understated, net income would have been overstated, and the carrying amount of the bonds would have been understated.
The November 30, 2009 transaction results in an ordinary loss. The loss is equal to the excess of the fair value of the cash and property transferred over the bonds’ carrying amount on November 30, 2009. This accounting is appropriate because the transaction involves the early extinguishment of debt.

If you have any additional questions, please contact me.

<table>
<thead>
<tr>
<th>Situation</th>
<th>Concepts</th>
<th>Bond Valuation</th>
<th>Amortization Schedule</th>
<th>Journal Entries</th>
<th>Communication</th>
<th>Research</th>
</tr>
</thead>
</table>

**APB 21, Para 13–14**

13. Determining an appropriate interest rate. The variety of transactions encountered precludes any specific interest rate from being applicable in all circumstances. However, some general guides may be stated. The choice of a rate may be affected by the credit standing of the issuer, restrictive covenants, the collateral, payment and other terms pertaining to the debt, and, if appropriate, the tax consequences to the buyer and seller. The prevailing rates for similar instruments of issuers with similar credit ratings will normally help determine the appropriate interest rate for determining the present value of a specific note at its date of issuance. In any event, the rate used for valuation purposes will normally be at least equal to the rate at which the debtor can obtain financing of a similar nature from other sources at the date of the transaction. The objective is to approximate the rate which would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions with the option to pay the cash price upon purchase or to give a note for the amount of the purchase which bears the prevailing rate of interest to maturity.

*Codification: 835-30-25-12*

**APB21, Para 14**

14. The selection of a rate may be affected by many considerations. For instance, where applicable, the choice of a rate may be influenced by (a) an approximation of the prevailing market rates for the source of credit that would provide a market for sale or assignment of the note; (b) the prime or higher rate for notes which are discounted with banks, giving due weight to the credit standing of the maker; (c) published risks that are traded in open markets; and (e) the current rate charged by investors for first or second mortgage loans on similar property.

*Codification: 835-30-25-13*
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