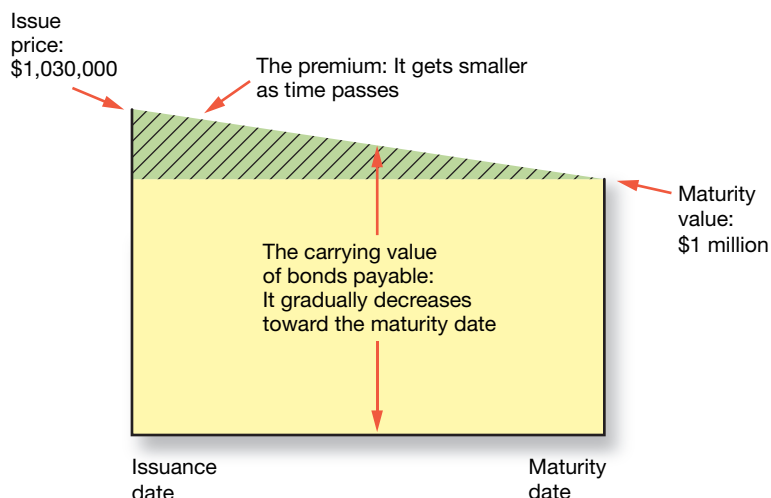


receives \$1,030,000 cash from the underwriter and records a liability equal to this amount. When these bonds mature in 20 years, however, Wells will owe its bondholders only the \$1 million *face value* of the bond issue. Thus, the company’s initial liability must somehow be *reduced* by \$30,000 over the 20 years that the bonds are outstanding.

The gradual decrease in the company’s liability is illustrated in Exhibit 10–7. Notice that the liability decreases at an average rate of \$1,500 per year (\$30,000 total increase ÷ 20-year life of the bond issue).

Exhibit 10-7
THE CARRYING VALUE OF A BOND PREMIUM



Bond Premium: A Reduction in the Cost of Borrowing When bonds are issued at a premium, the borrower repays less than the amount originally received at the date of issuance. Thus, any premium actually represents a reduction in the overall cost of borrowing. Unlike bonds issued at a discount, the interest expense associated with bonds issued at a premium will be *less* than the semiannual cash payment made to bondholders.

When the bonds are issued, the amount of any premium is credited to an account entitled *Premium on Bonds Payable*. Thus, Wells Corporation will record the March 1 issuance as follows:

| | | |
|---|-----------|-----------|
| Cash | 1,030,000 | |
| Premium on Bonds Payable | | 30,000 |
| Bonds Payable | | 1,000,000 |
| Issued 20-year bonds with \$1,000,000 face value to an underwriter at a price of 103. | | |

Wells Corporation’s liability at the date of issuance will appear in the balance sheet as follows:

| | |
|---------------------------------------|--------------------|
| Long-Term Liabilities | |
| Bonds payable | \$1,000,000 |
| Add: Premium on bonds payable | 30,000 |
| Carrying value of bonds payable | <u>\$1,030,000</u> |

Note that, because the Premium on Bonds Payable account has a credit balance, it is shown in the balance sheet as an *increase* in the face or par value of bonds payable.

Amortization of the Premium On March 1, 2005, Wells Corporation received \$1,030,000 from the underwriter. When the bonds mature 20 years later on March 1, 2025, the