

### **Is the current practice of bond-accrued interest payments fair? A view from an accounting academic**

With the exception of Hong Kong, whose debt market represents a small proportion of the equity market, bond financing in North America and many other parts of the world represents a significant portion of corporate financing.

Bondholders receive interest payments, usually once every six months, and anticipate bond appreciation through interest rate fluctuation. Inequity in the interest payment system If the bondholder maintains a security account with a financial institution, interest payments from the company will be credited to the account every six months.

However, the trading of bonds takes place every day. It would only be coincidental that trades fall on an interest payment day. As such, interest is accrued to the day of the trade on behalf of the selling bondholder, and is paid to the latter on the settlement date.

Instead of the company making the interest payment to the vendor, this accrued interest is added to the price paid by the buyer of the bonds and settled between the two transacting parties. This practice is deemed to be unfair to the new bondholder for the following reasons:

- A large number of bondholders may be unfamiliar with income tax and, when filing their tax returns, neglect to report the accrued interest paid to the previous bondholder as a deduction from the interest income reported on their tax slips. Instead, they may treat this as part of the adjusted cost base for the bond asset they acquired.
- This practice also penalises the new bondholder, in that the individual now has to fork out the accrued interest upon settlement and wait for the balance of the six-month period to be reimbursed from the company as interest payments take place every six months to whoever is registered as the bondholder on the date of the payment.

Both the points mentioned above could pose a financial cost to the bond purchaser. In the first case, marginal tax rates for capital gains and for interest income could be different, as in the case of Canada, where taxable capital gains are 50 per cent of the amount of the gain. In the second case, some may argue that the accrued interest could be insignificant.

## **An even playing field**

However, this would not be the case with institutional investors or retail investors with substantial portfolios. One may also argue that the interest on the accrued interest is small as nowadays, interest rates are very low throughout the world.

On the other hand, one should bear in mind that three decades ago interest rates, in general, exceeded 20 per cent.

Although it would be difficult to see a return to those days, it is apparent that pressure for rising interest rates exists as a result of inflation, the rise in commodity prices and the devaluation of the US dollar, owing to quantitative easing.

### **Alternatives to introduce equity into current practice**

The current practice of accrued-interest payment on bonds is for the convenience of bond issuers. There can be two ways to render the system more equitable.

The first is to have bond vendors wait until the interest payment date to receive the accrued-interest payment cheque directly from the company.

This would require companies to update their automated system to keep track of bond selling dates and the amount of accrued interest. It would also require brokerage houses and other financial institutions to automate a system whereby companies are instantaneously informed of these transactions.

The second alternative is to have accrued interest paid directly by the company immediately on the settlement date, instead of waiting for the interest payment date under instantaneous information dissemination as previously mentioned.

This is fair to both the purchaser and the vendor of bonds as the financial burden of interest on accrued interest is shifted back to the company that has the responsibility of payment of interest on time at any rate and the vendor of bonds can receive their interest upon termination of ownership of the asset.

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