

BONDS

This announcement is neither an offer to sell nor a solicitation of an offer to buy these securities.
The offer is made only by the Prospectus.

NEW ISSUE

January 4, 1982

\$100,000,000

Bally

MANUFACTURING CORPORATION

10% Convertible Subordinated Debentures Due 2006 - Dec. 31st

The Debentures are convertible into Common Stock at any time prior to maturity, unless previously redeemed, at a rate, subject to adjustment under certain conditions, of \$33.06 per share.

Price 100%

(Plus accrued interest, if any, from January 8, 1982)

Copies of the Prospectus may be obtained in any State in which this announcement is circulated only from such of the undersigned as may legally offer these securities in such State.

L. F. ROTHSCHILD, UNTERBERG, TOWBIN

Underwriters

BEAR, STEARNS & CO.

[A] Bond contracts are long-term debt instruments (contracts) which contain a predetermined (fixed) repayment schedule. The contract obligates the bond issuer (e.g. Bally Company) to make certain cash payments at specific future dates to the bond holder (e.g. an individual, company, or institutional investor) in exchange for a "negotiated" cash payment (i.e. issue price) from the bond holder at the time of issuance. The stated (coupon) interest rate coupled with the maturity (face) value of the bond specify the periodic cash payments to be received by the bond holder. For example, a "\$10,000, five-year, 8 percent bond paying annual interest" is shorthand for the following cash payment schedule:

Year:	0	1	2	3	4	5	
Cash	Issue	\$800	\$800	\$800	\$800	\$800	"interest"
Flow:--						\$10,000	"principal"

Bonds may be issued (placed) privately or publicly; however, only public placements are actively traded in the bond market. Investment banking firms (e.g. Salomon Brothers) act as brokers for both private and public placements.

The advertisement above is typical of "new issue" offers. Note that the "advertised" price is expressed as a percent of the face value of the bond; e.g. an asking price of "100" means that the company hopes to receive 100 percent of the face value at the date of issue.

[B] Interest Rate Fluctuations and Bond Prices

One unique feature of a bond contract is that the "return" (i.e. cash flows to the bond holder) is predetermined and is independent of the issue price. For example, an investor holding the bond outlined in [A] above will receive \$800 per year for five years and \$10,000 at the end of the fifth year regardless of the price at which the bond is issued.

At what price will the bond be issued? The price an investor is willing to pay for a bond, and the effective interest rate or return the investor demands from that bond, are jointly determined by the risk/return characteristics of the investor's opportunity set and the investor's perceptions about the inherent risk of the bond. Since the cash flows from holding the bond are fixed, the only way an investor can alter the effective interest rate (i.e. real return) on the bond is by paying more (or less) than the face value of the bond.

To illustrate, consider an investor who is willing to accept a "real return" of 6-percent on the bond described in [A]. Apparently this investor's opportunity set is limited to alternative investment projects which pay about 6-percent on a risk-adjusted basis. In order to earn a 6-percent return on the bond, the investor must purchase the bond (at the beginning of year 1) for a price not in excess of:

$$\begin{aligned}
 \$10,0000 \times .747 \text{ (Table 1 for 6\%, 5 yrs)} &= \$7,470.00 \\
 \$800 \times 4.212 \text{ (Table 2 for 6\%, 5 yrs)} &= \underline{3,369.60} \\
 \text{Price:} &= \$10,839.60
 \end{aligned}$$

On the other hand, an investor who demands a 10-percent real return on the investment (perhaps because the investor views the bond and company as particularly risky), would be unwilling to pay a price in excess of:

\$10,000 x .621 (Table 1 for 10%, 5 yrs)	=	\$6210.00
\$800 x 3.791 (Table 2 for 10%, 5 yrs)	=	3032.80
Price:		<u>\$9242.80</u>

It should come as no surprise, then, that the market price of a bond (either at the date of issuance or at subsequent dates) is influenced by changes in the prevailing market interest rate (T-bill rates, for example), and by changes in the "riskiness" of the company (likelihood of default on the bond). When the market interest rate increases (decreases), the market price for all outstanding bonds decreases (increases) since the bonds become relatively less (more) attractive when compared with other forms of investment.

[C] Bond Covenants

The bond issuer frequently adds "restrictive covenants" or clauses to the bond contract whereby the issuer voluntarily agrees to refrain from certain actions (e.g. issuing additional debt or paying dividends to shareholders). The motivation for these covenants is relatively straightforward. By agreeing to limit payments to shareholders and to restrict new debt issues, the company is providing the investor with an added margin of safety (i.e. making the bond less risky). In exchange for agreeing to restrict its activities, the company hopes to receive a higher issue price (i.e. lower effective interest rate) than would otherwise be the case.

For example, J.P. Stevens & Co. issued \$30,000,000 of convertible subordinated debentures in October of 1978. The offered issue price was 101; however the proceeds to the company amounted to 99 and 3/4. Although the debt was not secured, the company agreed: (a) to maintain a debt/equity ratio less than or equal to 1/2; and (b) to "not pay cash dividends or acquire any stock if the total payments would exceed consolidated net earnings after Oct. 31 1964 plus \$25,000,000 and net proceeds from sales of stock after said date."

[D] Accounting for Bond Issues

At issuance, the bond is recorded at the issue price (proceeds) which represents the present value of the liability as of the issue date discounted at the effective (market) interest rate applicable to the bond. Transactions costs are capitalized and amortized over the life of the bond.

If the issue price exceeds the face value of the bond, the bond is said to have been issued at a "premium"; conversely, if the issue price is less than the face value of the bond, the bond is said to have been issued at a "discount". Any difference between issue price and face value (i.e. the initial premium or discount) is amortized over the life of the bond.

- Consequently: (i) the bookvalue of the bond at the date of issuance equals the issue price of the bond;
- (ii) the bookvalue of the bond immediately prior to the maturity date equals the face value of the bond;
- (iii) the bookvalue of the bond between issue and maturity dates gradually approaches the face value of the bond as a result of amortizing the initial discount or premium.

Amortization and Interest Expense

The amount of discount (or premium) amortization and the amount of interest expense to be recorded in each period are codetermined using one of two GAAP methods.

Under the "straight-line" method, the amortization is given by:

$$\text{Amortization} = \left[\begin{array}{c} \text{discount} \\ \text{or} \\ \text{premium} \end{array} \right] \times (1/n) \quad \text{where } n = \text{number of interest periods}$$

Interest expense is given by:

$$\text{Expense} = \text{cash interest payment} \left\{ \begin{array}{l} + \text{discount amortization} \\ \text{or} \\ - \text{premium amortization} \end{array} \right.$$

Under the "effective interest" method, interest expense in each period is given by:

$$\text{Expense} = \left[\begin{array}{c} \text{bookvalue of the} \\ \text{bond at the begin.} \\ \text{of the period} \end{array} \right] \times (\text{effective interest rate})$$

The appropriate amortization is given by:

$$\text{Amortization} = \text{cash interest payment} - \text{interest expense}$$

Note that if the bond is issued at a premium (discount), the cash interest payment will always be greater (less) than the interest expense for the period.

Retirement

At retirement, interest expense to date must be recorded and then the difference between the cost to retire (i.e. cash paid to retire the bond) and the bookvalue of the bond at time of retirement is recorded as a gain or loss. Special problems arise when an outstanding bond is retired by issuing a new bond ("rollover") or by issuing stock.

(D) Example: Bond Issued at a Discount:

Acme Corporation is attempting to issue a \$10,000 ten-year bond with a semi-annual coupon rate of 5-percent that pays interest on June 30 and December 31. An investor, Jane Smith, is willing to buy the bond at a price which yields at least 8-percent semi-annually.

The maximum price Smith is willing to pay:

\$10,000	x	.215 (Table 1 for 8%, 20 periods)	=	\$2,150.00
\$500	x	9.818 (Table 2 for 8%, 20 periods)	=	4,909.00
				<u>Max. Price: \$7,059.00 *</u>

*Present value of the bond at 8% semi-annually market rate

Acme accepts Smith's bid and issues the bond on January 1, 1979, and makes the following journal entries for 1979 under the "effective interest method":

1/1/79:	Cash	\$7,059.00	
	Bond Payable		\$7,059.00

6/30/79:	Cash	\$500.00	
	Interest Expense*	\$564.72	
	Cash		\$500.00
	Bond Payable**		64.72

* $564.72 = 7059.00 \times .08$
 ** "discount amortization"
 Bookvalue of the bond: $7059.00 + 64.72$

12/31/79	Interest Expense*	\$569.90	
	Cash		\$500.00
	Bond Payable		69.90

* $569.90 = (7059.00 + 64.72) \times .08$
 ** "discount amortization"
 Bookvalue of the bond: $7,059.00 + 64.72 + 69.90$

(5)

Early Retirement

Suppose that by January 1, 1980 the market (effective) interest rate had risen to 10% (semi-annually). The current market price of the bond would be:

$$\begin{aligned} \$10,000 \times .180 \text{ (Table 1 for 10\%, 18 periods)} &= \$ 1,800.00 \\ \$500 \times 8.201 \text{ (Table 2 for 10\%, 18 periods)} &= \underline{4,100.50} \\ \text{Price:} &= \$ 5,900.50 \end{aligned}$$

The bookvalue of the bond on January 1, 1980 is \$7,193.62. Suppose the company retires the old bond by repurchasing it directly from the market. The retirement would be recorded as follows (ignoring transactions costs):

1/1/80:	Bond Payable	\$7,193.62	
	Gain on Retirement		\$1,293.12
	Cash		5,900.50

Moreover, assume the company immediately reissued the old bond at the prevailing market price:

1/1/80	Cash	\$5,900.12	
	Bond Payable		\$5,900.12

Ignoring income tax considerations, is the company "better" or "worse" off as a result of these two transactions? Why would a company "roll over" debt in this manner?

To continue with our illustration, the following entries would be made during 1980:

6/30/80	Interest Expense*	\$590.05	
	Cash		\$500.00
	Bond Payable		90.05

* $\$5,900.05 \times .10$ (new effective interest rate)

12/31/80	Interest Expense*	\$599.06	
	Cash		\$500.00
	Bond Payable		99.06

* $(\$5,900.50 + 90.05) \times .10$

(6)

Note that the 10% effective interest rate is used in 1980 only because the bond had been retired and reissued. In the absence of the January 1, 1980 transactions, Acme would continue to account for the bond using the original effective interest rate of 8%.

Issues for Further Consideration

(1) Suppose Jane Smith faced an entirely different set of investment opportunities back in January of 1979, and was willing to purchase the Acme bond at a price which would yield at least 4% semi-annually. Verify that the issue price in this case would be \$11,355.00. Provide all Acme Co. journal entries for 1979 related to the bond.

(2) What purpose do the "Discount on Bonds Payable" and "Premium on Bonds Payable" balance sheet accounts serve?

(3) Suppose Acme Company had used the "straight-line" method to account for the bond. How would this method alter the journal entries (and by implication, the financial statements) for 1979?

(4) Prepare journal entries to account for the bond during 1979 from the perspective of a bond holder (e.g. Jane Smith)