APB 21: Interest on Receivables and Payables

APB 21 STATUS

Issued: August 1971

Effective Date: For transactions on or after October 1, 1971

Affects: Amends ARB 43, Chapter 3A, paragraph 6(g)
Amends APS 4, paragraph 181

Affected by: Paragraph 13 amended by FAS 157, paragraph E1(b)
Paragraph 15 amended by FAS 34, paragraph 2
Paragraph 16 amended by FAS 34, paragraph 2, and FAS 159, paragraph C1
Paragraph 18 amended by FAS 157, paragraph E1(c)
Footnote 1 deleted by FAS 157, paragraph E1(a)
Footnote 8 amended by FAS 96, paragraph 204, and FAS 109, paragraph 287

Other Interpretive Pronouncements: AIN-APB 21, Interpretation No. 1
FIN 2 (Superseded by FAS 15)

AICPA Accounting Standards Executive Committee (AcSEC)

Related Pronouncements: SOP 97-1
SOP 01-6
PB 6

Issues Discussed by FASB Emerging Issues Task Force (EITF)

Affects: No EITF Issues

Interpreted by: No EITF Issues

Related Issues: EITF Issues No. 86-15, 86-28, 86-45, 96-12, and 98-14

INTRODUCTION

1. *Problem.* Business transactions often involve the exchange of cash or property, goods, or service for a note or similar instrument. The use of an interest rate that varies from prevailing interest rates warrants evaluation of whether the face amount and the stated interest rate of a note or obligation provide reliable evidence for properly recording the exchange and subsequent related interest. This Opinion sets forth the Board's views regarding the appropriate accounting when the face amount of a note does not reasonably represent the present value [i]**1** of the consideration given or received in the exchange. This circumstance may arise if the note is noninterest bearing or has a stated interest rate which is different from the rate of interest appropriate for the debt at the date of the transaction. Unless the note is recorded at its present value in this circumstance the sales price and profit to a seller in the year of the transaction and the purchase price and cost to the buyer are misstated, and interest income and interest expense in subsequent periods are also misstated. The primary objective of this Opinion is to refine the manner of applying existing accounting principles in this circumstance. Thus, it is not intended to create a new accounting principle.

2. *Applicability.* The principles discussed in this Opinion are applicable to receivables and payables which represent contractual rights to receive money or contractual obligations to pay money on fixed or

determinable dates, whether or not there is any stated provision for interest, except as stated in paragraphs 3 and 4. Such receivables and payables are collectively referred to in this Opinion as "notes." Examples are secured and unsecured notes, debentures, bonds, mortgage notes, equipment obligations, and some accounts receivable and payable.

3. Except that paragraph 16 covering statement presentation of discount and premium is applicable in all circumstances, this Opinion is not intended to apply to:

a. receivables and payables arising from transactions with customers or suppliers in the normal course of business which are due in customary trade terms not exceeding approximately one year;
b. amounts which do not require repayment in the future, but rather will be applied to the purchase price of the property, goods, or service involved (e.g., deposits or progress payments on construction contracts, advance payments for acquisition of resources and raw materials, advances to encourage exploration in the extractive industries);
c. amounts intended to provide security for one party to an agreement (e.g., security deposits, retainages on contracts);
d. the customary cash lending activities and demand or savings deposit activities of financial institutions whose primary business is lending money;
e. transactions where interest rates are affected by the tax attributes or legal restrictions prescribed by a governmental agency (e.g., industrial revenue bonds, tax exempt obligations, government guaranteed obligations, income tax settlements); and
f. transactions between parent and subsidiary companies and between subsidiaries of a common parent.[ii] **2**

4. This Opinion is also not intended to apply to, and the Board is not presently taking a position [iii] **3** as to, the application of the present value measurement (valuation) technique to estimates of contractual or other obligations assumed in connection with sales of property, goods, or service, for example, a warranty for product performance. This Opinion does not alter the accounting for convertible debt securities described in APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*.

5. Paragraph 16 of this Opinion amends paragraph 6(g) of Chapter 3A, *Current Assets and Liabilities* of Accounting Research Bulletin No. 43 which covers the balance sheet classification of unamortized debt discount.[iv] **4**

DISCUSSION

6. *Note received or issued for cash.* The total amount of interest during the entire period of a cash loan is generally measured by the difference between the actual amount of cash received by the borrower and the total amount agreed to be repaid to the lender. Frequently, the stated or coupon interest rate differs from the prevailing rate applicable to similar notes, and the proceeds of the note differ from its face amount. As the Appendix to this Opinion demonstrates, such differences are related to differences between the present value upon issuance and the face amount of the note. The difference between the face amount and the proceeds upon issuance is shown as either discount or premium, which is amortized over the life of the note.[v] **5**

7. *Unstated rights or privileges.* A note issued solely for cash equal to its face amount is presumed to earn the stated rate of interest. However, in some cases the parties may also exchange unstated (or stated) rights or privileges, which are given accounting recognition by establishing a note discount or premium account. In such instances, the effective interest rate differs from the stated rate. For example, a corporation may lend a supplier cash which is to be repaid five years hence with no stated interest. Such a noninterest bearing loan may be partial consideration under a purchase contract for supplier products at lower than the prevailing market prices. In this circumstance, the difference between the present value of the receivable and the cash loaned to the supplier is appropriately regarded as an addition to the cost of products purchased during the contract term. The note discount is amortized as interest income over the five-year life

of the note.

8. *Note received or issued in a noncash transaction.* A note exchanged for property, goods, or service represents two elements, which may or may not be stipulated in the note: (1) the principal amount, equivalent to the bargained exchange price of the property, goods, or service as established between the supplier and the purchaser and (2) an interest factor to compensate the supplier over the life of the note for the use of funds he would have received in a cash transaction at the time of the exchange. Notes so exchanged are accordingly valued and accounted for at the present value of the consideration exchanged between the contracting parties at the date of the transaction in a manner similar to that followed for a cash transaction. The difference between the face amount and the present value upon issuance is shown as either discount or premium, which is amortized over the life of the note.

9. *Determining present value.* If determinable, the established exchange price (which, presumably, is the same as the price for a cash sale) of property, goods, or service acquired or sold in consideration for a note may be used to establish the present value of the note. When notes are traded in an open market, the market rate of interest and market value of the notes provide the evidence of the present value. The above methods are preferable means of establishing the present value of the note.

10. If an established exchange price is not determinable and if the note has no ready market, the problem of determining present value is more difficult. To estimate the present value of a note under such circumstances, an applicable interest rate is approximated which may differ from the stated or coupon rate. This process of approximation is frequently called imputation, and the resulting rate is often called an imputed interest rate. Nonrecognition of an apparently small difference between the stated rate of interest and the applicable current rate may have a material effect on the financial statements if the face amount of the note is large and its term is relatively long.

OPINION

11. *Note exchanged for cash.* When a note [vi]**6** is received or issued solely for cash and no other right or privilege is exchanged, it is presumed to have a present value at issuance measured by the cash proceeds exchanged. If cash and some other rights or privileges are exchanged for a note, the value of the rights or privileges should be given accounting recognition as described in paragraph 7.

12. *Note exchanged for property, goods, or service.* When a note is exchanged for property, goods, or service in a bargained transaction entered into at arm's length, there should be a general presumption that the rate of interest stipulated by the parties to the transaction represents fair and adequate compensation to the supplier for the use of the related funds. That presumption, however, must not permit the form of the transaction to prevail over its economic substance and thus would not apply if (1) interest is not stated, or (2) the stated interest rate is unreasonable (paragraphs 13 and 14) or (3) the stated face amount of the note is materially different from the current cash sales price for the same or similar items or from the market value of the note at the date of the transaction. In these circumstances, the note, the sales price, and the cost of the property, goods, or service exchanged for the note should be recorded at the fair value of the property, goods, or services or at an amount that reasonably approximates the market value of the note, whichever is the more clearly determinable. That amount may or may not be the same as its face amount, and any resulting discount or premium should be accounted for as an element of interest over the life of the note (paragraph 15). In the absence of established exchange prices for the related property, goods, or service or evidence of the market value of the note (paragraph 9), the present value of a note that stipulates either no interest or a rate of interest that is clearly unreasonable should be determined by discounting all future payments on the notes using an imputed rate of interest as described in paragraphs 13 and 14. This determination should be made at the time the note is issued, assumed, or acquired; any subsequent changes in prevailing interest rates should be ignored.

♦ 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.

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 market rates for similar quality bonds; (d) current rates for debentures with substantially identical terms and risks that are traded in open markets; and (e) the current rate charged by investors for first or second mortgage loans on similar property.[vii] **7**

15. *Amortization of discount and premium.* With respect to a note which by the provisions of this Opinion requires the imputation of interest, the difference between the present value and the face amount should be treated as discount or premium [viii] **8** and amortized as ♦ interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period. This is the "interest" method described in and supported by ♦ paragraphs 16 and 17 of APB Opinion No. 12, *Omnibus Opinion—1967*. However, other methods of amortization may be used if the results obtained are not materially different from those which would result from the "interest" method.

♦ 16. *Statement presentation of discount and premium.* The discount or premium resulting from the determination of present value in cash or non-cash transactions is not an asset or liability separable from the note which gives rise to it. Therefore, the discount or premium should be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. It should not be classified as a deferred charge or deferred credit. The description of the note should include the effective interest rate; the face amount should also be disclosed in the financial statements or in the notes to the statements.[ix] **9** Amortization of discount or premium should be reported as ♦ interest in the statement of income. Issue costs should be reported in the balance sheet as deferred charges.

EFFECTIVE DATE

17. This Opinion shall be effective for transactions entered into on or after October 1, 1971. The Board believes that the conclusions as to balance sheet presentation and disclosure in paragraph 16 should apply to transactions made prior as well as subsequent to the issuance of this Opinion. However, this Opinion is not intended to require the discounting of notes existing on September 30, 1971 which were not previously discounted. Notes that were previously recorded in fiscal years ending before October 1, 1971 should not be adjusted. However, notes that have previously been recorded in the fiscal year in which October 1, 1971 occurs may be adjusted to comply with the provisions of this Opinion.

The Opinion entitled "Interest on Receivables and Payables" was adopted unanimously by the eighteen members of the Board.

APB 21 NOTES

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles.

Board Opinions are considered appropriate in all circumstances covered but need not be applied

to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin, Disclosure of Departures from Opinions of the Accounting Principles Board, *October 1964). Members of the Institute must assume the burden of justifying any such departures.*

Accounting Principles Board (1971)

Philip L. Defliese,
Chairman
Donald J. Bevis
Milton M. Broeker
Leo E. Burger
George R. Catlett
Joseph P. Cummings
Robert L. Ferst
Newman T. Halvorson
Robert Hampton, III
Emmett S. Harrington
Charles B. Hellerson
Charles T. Horngren

APPENDIX A

♦ 18. *Present value concepts.* Upon issuance of a note or bond, the issuer customarily records as a liability the face or principal amount of the obligation. Ordinarily, the recorded liability also represents the amount which is to be repaid upon maturity of the obligation. The value recorded in the liability account, however, may be different from the proceeds received or the present value of the obligation at issuance if the market rate of interest differs from the coupon rate of interest. For example, consider the issuance of a $1,000, 20-year bond which bears interest at 10% annually. If we assume that 10% is an appropriate market rate of interest for such a bond the proceeds at issuance will be $1,000. The bond payable would be recorded at $1,000 which represents the amount repayable at maturity and also the present value at issuance which is equal to the proceeds. However, under similar circumstances, if the prevailing market rate were more (less) than 10%, a 20-year 10% bond with a face amount of $1,000 would usually have a value at issuance and provide cash proceeds of less (more) than $1,000. The significant point is that, upon issuance, a bond is valued at (1) the present value of the future coupon interest payments *plus* (2) the present value of the future principal payments (face amount). These two sets of future cash payments are discounted at the prevailing market rate of interest (for an equivalent security) at the date of issuance of the debt. As the 8% and 12% columns show, premium or discount arises when the prevailing market rate of interest differs from the coupon rate:

	Assume prevailing market rate		
	10%	*8%*	*12%*
1. Present value of annual interest payments of $100 (the coupon rate of 10% of $1,000) for 20 years	$ 851	$ 982	$ 747
2. Present value of payment of the face amount of $1,000 at the end of Year 20	149	215	104
Present value and proceeds at date of issuance	$ 1,000	$ 1,197	$ 851

19. In the case of a $1,000 noninterest bearing 20-year note, where the prevailing market rate for comparable credit risks is 10%, the following valuation should be made:

1. Present value of no annual interest payments	$ 0
2. Present value of payment of the face amount of $1,000 at the end of Year 20	149
Present value and proceeds at date of issuance	$ 149

Comparison of the results of the illustrations in paragraph 18 with the illustration above shows the significant impact of interest.

20. *Illustrations of balance sheet presentation of notes which are discounted.*

	December 31	
	1970	*1969*
Example 1—Discount presented in caption		
NOTE RECEIVABLE FROM SALE OF PROPERTY:		
$1,000,000 face amount, noninterest bearing, due December 31, 1975 (less unamortized discount based on imputed interest rate of 8%—1970, $320,000; 1969, $370,000)	$ 680,000	$ 630,000
Example 2—Discount presented separately		
NOTE RECEIVABLE FROM SALE OF PROPERTY:		
Noninterest bearing note due December 31, 1975	$ 1,000,000	$ 1,000,000
Less unamortized discount based on imputed interest rate of 8%	320,000	370,000
Note receivable less unamortized discount	$ 680,000	$ 630,000
Example 3—Several notes involved		
LONG-TERM DEBT (Note 1):		
Principal amount	$24,000,000	$ 24,000,000
Less unamortized discount	2,070,000	2,192,000
Long-term debt less unamortized discount	$21,930,000	$ 21,808,000

Note 1—Long-Term Debt

Long-term debt at December 31, 1970 consisted of the following:

	Principal	*Unamortized Discount*
6% subordinated debentures, due 1984 (discount is based on imputed interest rate of 7%)	$20,000,000	$ 1,750,000
6 1/2% bank loan, due 1973	3,000,000	-
Noninterest bearing note issued in connection with acquisition of property, due 1975 (discount is based on imputed interest rate of	1,000,000	320,000
Total	$24,000,000	$ 2,070,000

[i]♦ APB21, Footnote 1--*Present value* is the sum of the future payments discounted to the present date at an appropriate rate of interest. The Appendix contains a description of the valuation process.

[ii]APB21, Footnote 2--The Board has deferred consideration of the treatment of transactions between such companies pending consideration of the subject of reporting on components of a business enterprise and completion of the Accounting Research Study on intercorporate investments.

[iii]APB21, Footnote 3--In ♦ paragraph 6 of APB Opinion No. 10, *Omnibus--1966*, the Board concluded that deferred income taxes should not be accounted for on a discounted (present value) basis. That conclusion is not modified by this Opinion.

[iv]APB21, Footnote 4--This Opinion amends APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, to the extent that it relates to recording and disclosing interest on receivables and payables.

[v]APB21, Footnote 5--For example, if a bond is issued at a discount or premium, such discount or premium is recognized in accounting for the original issue. The coupon or stated interest rate is not regarded as the effective yield or market rate. Moreover, if a long-term noninterest bearing note or bond is issued, its net proceeds are less than face amount and an effective interest rate is based on its market value upon issuance. As the Appendix illustrates, the coupon or stated rate of interest and the face amount of a note or bond may *not* be the appropriate bases for valuation. The presumption that market values provide the evidence for valuation must be overcome before using coupon or stated rates and face or maturity amounts as the bases for accounting.

[vi]APB21, Footnote 6--Paragraphs 2, 3 and 4 describe the applicability of this Opinion.

[vii]APB21, Footnote 7--A theory has been advanced which states that no imputation of interest is necessary if the stated interest rate on a note receivable exceeds the interest cost on the borrowed funds used to finance such notes. The Board considers this theory unacceptable for reasons discussed in this Opinion.

[viii]APB21, Footnote 8--Differences between the recognition for financial accounting purposes and income tax purposes of discount or premium resulting from determination of the present value of a note should be treated as ♦ timing differences in accordance with ♦ APB Opinion No. 11, *Accounting for Income Taxes*.

[ix]APB21, Footnote 9--Refer to the Appendix for illustrations of balance sheet presentation.