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March 20, 1980

ISSUES PAPER

ACCOUNTING FOR TRANSFERS
OF RECEIVABLES
WITH RECOURSE

Prepared by
The Task Force on
Off Balance Sheet Financing Arrangements
Accounting Standards Division
American Institute of Certified Public Accountants

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INTRODUCTION

1. Enterprises frequently transfer their receivables to financial institutions. A transfer may be without recourse to the transferor, with the entire risk borne by the acquirer, or it may be with full or partial recourse to the transferor. In a recourse arrangement, the transferor retains all or a portion of the credit risk and may incur a loss if a receivable is not collected from the debtor in full.
2. Some retailers have transferred to finance institutions, receivables with recourse to the retailers if customers failed to pay. As this practice increased, some large retailers formed subsidiaries with the finance companies that acquired their receivables. Today, many industries -- such as heavy equipment manufacturers, chemical companies, and retailers -- transfer large dollar amounts of receivables to finance companies.
3. In Statement of Position (SOP) 74-6, "Recognition of Profit on Sales of Receivables with Recourse," the division concluded that enterprises should use the delayed recognition method to report profit on such transfers. The division issued that SOP because it was concerned with the practice in certain industries of recognizing profit at the date of transfer of receivables transferred with recourse even though the transfer may have required the transferor to repay the financial institution if the customer defaulted.
4. This issues paper deals with whether a transfer of receivables with recourse to the transferor should be accounted for as a borrowing or as a sale. The following paragraphs discuss authoritative and other accounting literature, review present practice, and identify the issues.

Background and Types of Arrangements

5. Recourse is defined in SOP 74-6 (footnote 1) as

the contractual right of a purchaser of receivables to demand payment from the seller of such receivables in the event of default by the debtor. However, the term may also refer to agreements between a buyer and a seller of receivables such as guarantees by the seller of a "yield" to the buyer on the receivables sold, which constitute "recourse" in substance.
6. The forms of the recourse arrangements vary. For example, if a debtor defaults in a full recourse arrange-

ment, the transferor of the receivable with recourse must reimburse the acquirer in full regardless of whether the property is recovered from the debtor.

7. Other full recourse arrangements specify that if the debtor defaults, the acquirer of the receivables is obligated to return any collateral to the transferor before the transferor is compelled to perform under the recourse arrangement. Sometimes the recourse provision is effective only if the property is reacquired within a stated period of time, such as 90 days. The recourse agreement may state that the acquirer of the receivable is required to sell the goods he repossesses, apply the proceeds against the balance of the receivables, and charge the transferor for any deficiency in the receivable balances.

8. In a partial recourse arrangement, the transferor's liability may be limited to stipulated amounts or percentages of receivables transferred, such as 10%. However, in this type of arrangement the acquirer is generally still assured that he will recover his investment after considering the value of the collateral securing the receivables and the overall loss history of the types of receivables.

9. Some recourse arrangements are maintenance agreements in which the transferor guarantees the acquirer a specified return or profit on the transfer. For example, the transferor guarantees that the acquirer will earn 10% after provisions have been made for all expenses.

10. In some maintenance agreements, the transferor guarantees the acquirer will maintain specified financial ratios, such as debt to equity or working capital ratios. Companies usually use these types of agreements when they transfer receivables to finance subsidiaries.

11. Although the forms of recourse arrangements vary, the transferor retains some credit risks under all types of recourse arrangements.

PRESENT PRACTICE

12. Transfers of receivables with recourse are accounted for either as borrowings or as sales. Under a borrowing, the enterprise records a liability for the funds received and continues to present the receivables on the balance sheet.

13. Most enterprises account for the transfers as sales and remove the receivables from the balance sheet. The enterprises provide for estimated losses at the date of the transfer of the receivables transferred with recourse and disclose the contingent liabilities in notes to the financial statements.

14. Disclosure of such contingencies is required by paragraph 12 of SFAS No. 5, "Accounting for Contingencies," which states:

Certain loss contingencies are presently being disclosed in financial statements even though the possibility of loss may be remote. The common characteristic of those contingencies is a guarantee, normally with a right to proceed against an outside party in the event that the guarantor is called upon to satisfy the guarantee. Examples include (a) guarantees of indebtedness of others, (b) obligations of commercial banks under "standby letters of credit", and (c) guarantees to repurchase receivables (or, in some cases, to repurchase the related property) that have been sold or otherwise assigned. The Board concludes that disclosure of those loss contingencies, and others that in substance have the same characteristic, shall be continued. The disclosure shall include the nature and amount of the guarantee. Consideration should be given to disclosing, if estimable, the value of any recovery that could be expected to result, such as from the guarantor's right to proceed against an outside party. (Emphasis added.)

CURRENT AND OTHER AUTHORITATIVE LITERATURE

15. We found no specific pronouncements other than the cited portion of SFAS No. 5 that deals with the balance sheet presentation of receivables transferred with recourse. However, we examined pronouncements on general principles to see if they provide clear guidance. The following paragraphs summarize general principles relevant to the issues.

16. The accounting literature stresses that the economic substance of a transaction should determine the method of accounting

if it differs from the legal form. APB Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," states (paragraph 127) that the economic substance as opposed to mere legal form should govern the accounting for a transaction. The concept of substance over form is essential to the resolution of the accounting principles relating to transfers of receivables with recourse.

17. The Financial Accounting Standards Board, in Statement of Financial Accounting Standards No. 13, "Accounting for Leases," and No. 28, "Accounting for Sales with Leasebacks," states that if a transferor retains all the benefits and risks of ownership of the property "sold," the transfer is merely a borrowing. SFAS No. 13, paragraph 21 states:

The sale of property subject to an operating lease, or of property that is leased by or intended to be leased by the third party purchaser to another party, shall not be treated as a sale if the seller or any party related to the seller retains substantial risks of ownership in the leased property.

Paragraph 22 further states that the transfers described in paragraph 21 are, in effect, collateralized borrowings and should be accounted for as such. SFAS No. 28 provides that only if the transferor-lessee relinquishes all benefits in the property transferred (retaining only a minor portion for use) should the transfer and leaseback be accounted for as separate transactions.

18. Also, paragraph 43 of SFAS No. 19, "Financial Accounting and Reporting by Oil and Gas Producing Companies," gives examples of certain mineral property conveyances and states that such transfers are in substance borrowings repayable in cash or its equivalent and should be accounted for as borrowings. Paragraph 43 states:

- a. Enterprises seeking supplies of oil or gas sometimes make cash advances to operators to finance exploration in return for the right to purchase oil or gas discovered. Funds advanced for exploration that are repayable by offset against purchases of oil or gas discovered, or in cash if insufficient oil or gas is produced by a specified date, shall be accounted for as a receivable by the lender and as a payable by the operator.

- b. Funds advanced to an operator that are repayable in cash out of the proceeds from a specified share of future production of a producing property, until the amount advanced plus interest at a specified or determinable rate is paid in full, shall be accounted for as a borrowing. The advance is a payable for the recipient of the cash and a receivable for the party making the advance.

19. In Statement of Position (SOP) 74-6, "Recognition of Profit on Sales of Receivables with Recourse," the division concludes that the profit recognition on receivables transferred with recourse should be delayed. The SOP also states that "the delayed recognition method emphasizes the financing aspects of the sale of receivables." Delayed recognition of profit on transfer is based on a presumption that the transfer should be accounted for as a borrowing in which monies are borrowed and assets are pledged as collateral.

20. Paragraph 11 of SOP 75-1, "Revenue Recognition When Right of Return Exists," states that

If the seller is exposed to the risks of ownership through return of the property, it should be presumed that the transactions should not be recognized currently as sales unless all of the following conditions are met (and the usual conditions for recording sales not involving right of return have also been satisfied).

21. In SOP 78-8, "Accounting for Product Financing Arrangements," the division concludes that the sponsor of a product financing arrangement, who bears all the risks and rewards of ownership of the product, should report the assets and related liabilities that result from such arrangements in its financial statements.

ISSUES

22. The basic issue is: Are there types of recourse arrangements that should cause the transfer of receivables to be accounted for as borrowings rather than as sales? If the answer to the basic issue is yes, the next question is: what elements of recourse arrangements should cause the transfer to be accounted for as borrowings?

Arguments for Borrowing

23. The arguments advanced for accounting for a transfer of receivables with recourse as a borrowing are as follows:

- The transfer of receivables with recourse is, in substance, a type of borrowing, by the transferor. When a transfer price is negotiated, the process is analogous to negotiation between a borrower and a lender. In determining an acceptable return for his investment, the acquirer of receivables takes into account the transferor's retention of certain risks, for example, his credit standing. The acquirer's return is then reflected in the dollar amounts for which the receivables are acquired.
- In a transfer of receivables with recourse, the transferor's risks are not diminished by the transfer. The transferor's risks are retained by the recourse provision, which effectively pledges his assets as security for the sum advanced by the acquirer.
- The transfer of receivables with recourse is no different from the transfer of property in which the transferor retains a substantial risk, and the literature supports recording such transfers as borrowings. (See paragraphs 15 through 21.)

Arguments for Sales

24. The arguments advanced for accounting for a transfer of receivables with recourse as a sale are as follows:

- A transfer of receivables with recourse is a completed transaction. It is a three-party transaction, including a transferor, an acquirer, and a debtor. The acquirer must be concerned about the debtor's credit standing and ability to fulfill his obligations; therefore, the transferor's recourse obligations are only of secondary importance to the acquirer.

- The transferor's recourse obligations are similar to a manufacturer's obligations under product warranties or guarantees. In effect, the transferor guarantees the quality of the receivables transferred and should account for the consequences of such a guarantee in the same manner as a manufacturer who accounts for this obligation under product warranties.
- The receivables transferred with recourse may be of such a high quality that the probability of the debtor defaulting is remote. In such circumstances, a sale should be recorded since, in substance, the risk of recourse is slight and should be ignored.
- The present practice of accounting for these transfers as sales together with disclosure of the contingent liability is supported by SFAS No. 5, "Accounting for Contingencies," which refers to guarantees to purchase receivables. (See paragraph 14.)

Characteristics of Recourse Arrangements

25. If it is concluded that a transfer of receivables with recourse may be a financing transaction, it will be necessary to address the next issue: what characteristics of recourse arrangements should cause them to be accounted for as financing transactions?

26. Recourse arrangements may have the following characteristics (repeated here for convenience):

- a) Full recourse, whereby, if the debtor defaults, the transferor of receivables with recourse must reimburse the acquirer in full, regardless of whether the property is recovered from the debtor. (See paragraph 6.)
- b) Full recourse as described above except that, for the recourse provision to become effective, the acquirer of the receivable must reacquire the property from the debtor. Sometimes the recourse provision is effective only if the property is reacquired within a stated period of time such as 90 days. (See paragraph 7.)

- c) Partial recourse in which the transferor's liability is limited to a specific amount or a percentage of the receivables transferred. For example, the transferor's liability maybe limited to 10% of the receivables transferred. (See paragraph 8.)
- d) Maintenance agreements whereby the transferor guarantees the acquirer a specified return or profit on the transfer. For example, the transferor guarantees that the acquirer will earn 10% after provisions have been made for all expenses. (See paragraphs 9 and 10.)

27. The issue of probability of occurrence is inherent in all the recourse arrangements described above. Some believe that certain recourse arrangements should be accounted for as borrowings regardless of the probability that the recourse provision will be exercised. They believe that full recourse arrangements as described in paragraphs 6 and 26(a) should be considered borrowings, since the recourse provisions are without limitations.

28. Others believe that the transfers should be accounted for as sales regardless of the nature of the recourse provision unless it is probable that the recourse provision will be exercised. Proponents of this position base their argument on the concepts in Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies."

29. The recourse agreement described in paragraphs 7 and 26(b) requires the acquirer to reacquire the property from the debtor before the recourse provision becomes effective. The transferor, therefore, may incur a loss only if the acquirer locates the debtor's property. Some believe that the limitation is not sufficient to prevent the transaction from being accounted for as a borrowing. They argue that the property is almost always recovered and that since the agreement specifies only recovery and not the condition of the property, the provision is equivalent to full recourse.

30. Others argue that the types of recourse arrangements discussed in paragraphs 7 and 26(b) should be accounted for as borrowings only if it is probable that the acquirer will reacquire the property. As stated in paragraph 28, proponents of this position base their argument on the concepts in Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies."

31. Some believe that partial recourse arrangements, as described in paragraphs 8 and 26(c) should be accounted for as borrowings. They argue that the limitations are usually set high enough to place the entire risk of loss on the transferor and that the limitation should be ignored as it does not serve to limit the transferor's risks. In the example described in paragraph 8 and 26(c), the 10% limitation may be placed on receivables whose loss experience has averaged 2%.

32. Others argue that the partial recourse arrangement described in paragraph 8 and 26(c) should be accounted for as a sale since some of the risk is transferred to the acquiror.

33. Some also believe that maintenance agreements described in paragraphs 9 and 10, and 26(d) are equivalent to full recourse arrangements and should be accounted for as borrowings. They also argue that maintenance agreements are written to protect either the enterprise that acquires the receivable or its creditors from the risk of loss. Maintenance agreements, which are most often between related parties are, in substance, the same as partial recourse agreements as described in paragraphs 8 and 26(c).

34. Others believe that maintenance agreements as described in paragraphs 9, 10, and 26(d) should be accounted for as sales. They argue that maintenance agreements are similar to warranties, and the agreements should therefore not prevent the transfers from being accounted for as sales. They also argue that the limitations should cause the transfers to be viewed as sales since some risks are transferred to the acquirers.

35. Some argue further that maintenance agreements are usually between related parties and consideration of such agreements should be deferred until the entire question of "related party transactions" is addressed. Furthermore, since maintenance agreements are frequently between a company and its finance subsidiary, such agreements should be considered as part of project on accounting for finance subsidiaries and should not be addressed in this issues paper.

* * * * *

ADVISORY CONCLUSIONS

36. The following are the advisory conclusions of the division on the issues presented in paragraph 22.

- The committee agreed, 9-4, that regardless of the probability of the debtor defaulting, the full recourse arrangements described in paragraph 6 and 26(a) should be considered borrowings. The four who dissented agreed that the transfer described in paragraphs 6 and 26(a) should be accounted for borrowings only if it is probable that the debtor will default.
- The committee agreed, 13-0, that the recourse arrangements described in paragraphs 7, 8, 9, 10, 26(b), 26(c), and 26(d), have characteristics of borrowings, depending on the probability that the debtors will default and thereby cause the risk to remain with the transferors.