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Statement of Position on

78-8

Accounting for Product Financing Arrangements

December 26, 1978

Proposal to Financial Accounting Standards Board

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

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The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

AICPA **American Institute of Certified Public Accountants**
1211 Avenue of the Americas, New York, N.Y. 10036 (212) 575-6200

December 26, 1978

Donald J. Kirk, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, CT 06905

Dear Mr. Kirk:

The accompanying statement of position, Accounting for Product Financing Arrangements, has been prepared on behalf of the accounting standards division by the AICPA Task Force on Off-Balance-Sheet Financing Arrangements and approved by the Accounting Standards Executive Committee.

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience.

Sincerely yours,

Arthur R. Wyatt

Arthur R. Wyatt
Chairman
Accounting Standards Executive Committee

cc: Securities and Exchange Commission

Accounting Standards Division

Accounting Standards Executive Committee

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Accounting for Product Financing Arrangements

1. A number of methods have been developed whereby an entity finances inventory of product or materials without reporting in its balance sheet the liability or the related inventory. For example, a company transfers ("sells") a product to another party and in a related transaction agrees to repurchase the product or processed goods of which the product is a component at a specified price over a specified period. The other party ("transferee" or "purchaser"), using the product and at times the financing arrangement as collateral, may borrow against the value of the product from a lending institution or other credit grantor and remit the proceeds to the company as payment for the product. As the terms of the financing arrangement are fulfilled by the company making the original transfer ("sale"), the transferee ("purchaser") reduces its borrowing from the financial institution.

2. For transactions of that type, the accounting standards division believes guidance is necessary to determine whether the company that "sells" the product and in a related transaction agrees to repurchase the product, has in substance transferred the risks and rewards of ownership of the product. Based on that determination, a decision can be reached on whether the transferor should account for the transaction as a sale or as a financing transaction. In this document, such transactions are referred to as "product financing arrangements."

3. Product financing arrangements include agreements in which a sponsor (the company seeking to finance product acquisition or the holding of product for future use or resale)—

a. Sells a product to another entity (the company through which the financing flows), and in a related transaction agrees to buy the product back.

b. Is a party to an arrangement whereby an entity purchases a product on the sponsor's behalf, and the sponsor in a related transaction agrees to buy the product from the entity.

c. Controls the disposition of the product that has been acquired by the other entity in accordance with the arrangements described in either (*a*) or (*b*) above.

In all of the foregoing cases, the sponsor agrees to purchase the product, or processed goods of which the product is a component, from the other entity at specified prices over specified periods or, to the extent that it does not do so, guarantees resale prices to third parties (see paragraph 4 (*a*)(i) below). The Appendix contains an example of each of the types of arrangements described in (*a*) and (*b*) above.

4. For purposes of this statement of position, product financing arrangements apply to products[1] that have been produced by or were originally acquired by the sponsor or acquired by another entity on behalf of the sponsor and have the following characteristics:

a. The financing arrangement requires the sponsor to purchase the product or processed goods of which the product is a component at specified prices. The components of the prices related to the product are not subject to future market price fluctuations except for fluctuations due to finance and holding costs. This characteristic is also present if either of the following circumstances exists:

  (i) The specified prices in the financing arrangement are in the form of resale price guarantees under which the sponsor agrees to make up any difference between the specified price and the resale price for products sold to third parties or if the sponsor does not repurchase the product.

  (ii) The financing arrangement is in the form of (*a*) an election (option) for the sponsor to purchase the product, the economic effect of which compels the sponsor to purchase the product—for example, an option arrangement that provides for a significant penalty if the spon-

[1] Unmined or unharvested natural resources are not considered to be product for the purposes of this statement of position.

sor does not exercise the purchase election or (*b*) an election (option) whereby the other entity can require the sponsor to purchase the product.

b. The predetermined prices to be paid by the sponsor cover at least substantially all costs associated with acquisition of the product plus holding costs and including interest and any related fee charged by the other entity.

5. Other characteristics that commonly exist in product financing arrangements but that are not necessarily present in all such arrangements are—

a. The entity that purchases the product from the sponsor or acquires it directly from a third party on behalf of the sponsor was established expressly for that purpose or is an existing trust, nonprofit entity, or credit grantor.

b. The product covered by the financial arrangement is to be used or sold by the sponsor, although a portion may be sold by the other entity directly to third parties.

c. The product subject to the financing arrangement is stored on the premises of the sponsor.

d. The debt of the other entity is guaranteed by the sponsor.

Scope

6. This statement of position contains the accounting standards division's recommendations for accounting for product financing arrangements by enterprises, including nonprofit organizations, that present financial statements prepared in conformity with generally accepted accounting principles. This statement of position is not intended to modify any of the conclusions in SOP 75-1, *Revenue Recognition When Right of Return Exists,* and does not apply to transactions that qualify as sales in accordance with the provisions of that statement.

Present Practice

7. The products and obligations under product financing arrangements are sometimes reported as assets and liabilities in the financial statements of the sponsor, but often they are not,

although the obligations are sometimes disclosed as commitments. Often, financing and holding costs incurred by the other entity are not reported by the sponsor until the product is acquired from the other entity. Those costs are sometimes considered part of product cost irrespective of the sponsor's accounting for similar costs applicable to its products that are not subject to a product financing arrangement.

The Division's Conclusion

8. The division believes that, in substance, the sponsor of a product financing arrangement that demonstrates all of the characteristics described in paragraph 4 bears substantially all of the risks and rewards of ownership of the product. The assets and related liabilities that result from such product financing arrangements should be reported in the financial statements of the sponsor.

9. Products and obligations under product financing arrangements that contain all the characteristics described in paragraph 4 should be accounted for by the sponsor as follows:

a. If a sponsor sells a product to another entity and, in a related transaction, agrees to buy back the product or processed goods of which the product is a component the sponsor should record a liability at the time the proceeds are received from the other entity to the extent that the product is covered by a financing arrangement. The sponsor should not record the transaction as a sale and should not remove the product from its balance sheet except for product not covered by a financing arrangement. Such a product financing arrangement, despite its form, does not in substance represent a sale or purchase by the sponsor, but rather a method of financing its product.

b. If the sponsor is a party to an arrangement whereby an entity buys a product on the sponsor's behalf and, in a related transaction, the sponsor agrees to buy the product or processed goods of which the product is a component from the entity, the sponsor should record the asset and the related obligation when the product is acquired by the other entity.

10. Costs of the product, excluding processing charges, in excess of the sponsor's original production or purchase cost or the other entity's acquisition costs represent financing and holding costs. The sponsor should account for such costs in accordance with its applicable accounting policies when the costs are incurred by the other entity. For example, if insurance and other holding costs are ordinarily treated as period costs by the sponsor, similar costs associated with the product covered by financing arrangements should be accrued and expensed as period costs by the sponsor as incurred by the other entity.

Transition

11. An accounting change to adopt the recommendations of this statement of position should be made for balance sheets as of December 20, 1979, and later. Early adoption of these recommendations and retroactive application is encouraged.

12. The nature of the change in an enterprise's financial statements resulting from application of this statement should be disclosed.

APPENDIX

Examples of a Product Financing Arrangement

Two cases are presented to illustrate application of the recommendations expressed in paragraphs 8 through 10. The facts assumed in the cases are illustrative only and are not intended to modify or limit in any way the recommendations in paragraphs 8 through 10. The facts assumed in each case could vary in one or more respects without altering the accounting recommendations.

Case 1

"Sale" and related agreement to repurchase (paragraph 3(*a*)).

Facts

A company (sponsor) arranges for an entity to acquire a portion of its inventory. The entity's sole asset is the transferred inventory that is in turn used as collateral for bank financing. The proceeds of the bank financing are then remitted to the sponsor. The debt of the entity is guaranteed by the sponsor. The inventory is stored in a public warehouse during the holding period. The company, in connection with the "sale" (legal title passes to the entity), enters into a financing arrangement under which—

a. The company agrees to pay all costs of the entity associated with the inventory including holding and storage costs.

b. The company agrees to pay the entity interest on the purchase price of the inventory equivalent to the interest and fees incurred in connection with the bank financing.

c. The company agrees to repurchase the inventory from the entity at a specified future date for the same price originally paid by the entity to acquire the inventory irrespective of changes in market prices during the holding period.

d. The entity agrees not to assign or otherwise encumber the inventory during its ownership period, except to the extent of providing collateral for the bank financing.

Accounting Treatment

In the product financing arrangement outlined above, all of the characteristics in paragraph 4 are present; accordingly, the company should neither record the transaction as a sale of inventory nor remove the inventory from its balance sheet. The company should record a liability at the time the proceeds are received from the entity. Financing and holding costs should be accrued by the company as incurred by the entity and treated in accordance with the company's normal accounting policies for such costs.

Case 2

A sponsor arranges for an entity to buy product on the sponsor's behalf with a related agreement to purchase the product from the entity (paragraph 3(*b*)).

Facts

A company (sponsor) arranges for a newly created trust to acquire on its behalf an existing supply of fuel. In a related agreement, the sponsor agrees to buy the fuel from the entity over a specified period and at specified prices. The prices established are adequate to cover all holding and financing costs of the trust. The trust finances the purchase of fuel using the fuel and the agreement as collateral.

Accounting Treatment

In the product financing arrangement outlined above, all of the characteristics in paragraph 4 are present; accordingly, the sponsor should report the asset (fuel) and the related liability in its financial statements when the fuel is acquired by the other entity (time of acquiring the fuel). Financing and holding costs should be accrued by the sponsor as incurred by the trust and treated in accordance with the sponsor's accounting policies for holding and financing costs related to inventory items.