

# Statement of Financial Accounting Standards No. 49

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Accounting for Product Financing Arrangements

June 1981



Financial Accounting Standards Board  
of the Financial Accounting Foundation  
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# FAS 49: Accounting for Product Financing Arrangements

## FAS 49 Summary

This Statement specifies criteria for determining when an arrangement involving the sale of inventory is in substance a financing arrangement. A product financing arrangement is a transaction in which an enterprise sells and agrees to repurchase inventory with the repurchase price equal to the original sale price plus carrying and financing costs, or other similar transactions. This Statement requires that a product financing arrangement be accounted for as a borrowing rather than as a sale.

## INTRODUCTION

1. As discussed in FASB Statement No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters*, the FASB is extracting the specialized <sup>1</sup> accounting and reporting principles and practices from AICPA Statements of Position (SOPs) and Guides on accounting and auditing matters and issuing them in FASB Statements after appropriate due process. This Statement extracts the specialized principles and practices from SOP 78-8, *Accounting for Product Financing Arrangements*, and establishes accounting and reporting standards for product financing arrangements.

2. The Board has concluded that it can reach an informed decision on the basis of existing information without a public hearing and that the effective date and transition specified in paragraph 11 are advisable in the circumstances.

## APPLICABILITY AND SCOPE

3. Product financing arrangements include agreements in which a sponsor (the enterprise seeking to finance product pending its future use or resale):

- a. Sells the product to another entity (the enterprise through which the financing flows), and in a related transaction agrees to repurchase the product (or a substantially identical product);
- b. Arranges for another entity to purchase the product on the sponsor's behalf and, in a related transaction, agrees to purchase the product from the other entity; or
- c. Controls the disposition of the product that has been purchased by another 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 (paragraph 5(a)(1)). Appendix C illustrates each of the types of arrangements described in (a) and (b) above.

4. 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 purchases it directly from a third party on behalf of the sponsor was established expressly for that purpose or is an existing trust, nonbusiness organization, or credit grantor.
- b. The product covered by the financing 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 covered by the financing arrangement is stored on the sponsor's premises.
- d. The debt of the entity that purchases the product being financed is guaranteed by the sponsor.

5. This Statement applies to product financing arrangements for products <sup>2</sup> that have been produced by or were originally purchased by the sponsor or purchased by another entity on behalf of the sponsor and have both of the following characteristics:

- a. The financing arrangement requires the sponsor to purchase the product, a substantially identical product, or processed goods of which the product is a component at specified prices. The specified prices are not subject to change except for fluctuations due to finance and holding costs. This characteristic of predetermined prices also is present if any of the following circumstances exists:
  - (1) 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.
  - (2) The sponsor is not required to purchase the product but has an option 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 sponsor does not exercise the option to purchase.
  - (3) The sponsor is not required by the agreement to purchase the product but the other entity has an option whereby it can require the sponsor to purchase the product.

- b. The payments that the other entity will receive on the transaction are established by the financing arrangement, and the amounts to be paid by the sponsor will be adjusted, as necessary, to cover substantially all fluctuations in costs incurred by the other entity in purchasing and holding the product (including interest).<sup>3</sup>
6. This Statement does not modify any of the provisions of FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*, and does not apply to transactions for which sales revenue is recognized currently in accordance with the provisions of that Statement.
7. The Addendum to APB Opinion No. 2, *Accounting for the "Investment Credit,"* (paragraph 2) states that ". . . differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process . . ." and discusses the application of generally accepted accounting principles to regulated industries. Accordingly, the provisions of the Addendum govern the application of this Statement to those operations of an enterprise that are regulated for rate-making purposes on an individual-company-cost-of-service basis.

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

8. Product and obligations under product financing arrangements that have both of the characteristics described in paragraph 5 shall 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 repurchase the product (or a substantially identical product) or processed goods of which the product is a component, the sponsor shall record a liability at the time the proceeds are received from the other entity to the extent that the product is covered by the financing arrangement. The sponsor shall not record the transaction as a sale and shall not remove the covered product from its balance sheet.
  - b. If the sponsor is a party to an arrangement whereby another entity purchases a product on the sponsor's behalf and, in a related transaction, the sponsor agrees to purchase the product or processed goods of which the product is a component from the entity, the sponsor shall record the asset and the related liability when the product is purchased by the other entity.
9. Costs of the product, excluding processing costs, in excess of the sponsor's original production or purchase costs or the other entity's purchase costs represent financing and holding costs. The sponsor shall account for such costs in accordance with the sponsor's accounting policies applicable to financing and holding costs as those costs are incurred by the other entity. For example, if insurance costs ordinarily are accounted for as period costs by the sponsor, similar costs associated with the product covered by financing arrangements shall be expensed by the sponsor as those costs are incurred by the other entity. Interest costs associated with the product covered by financing arrangements shall be identified separately and accounted for by

the sponsor in accordance with FASB Statement No. 34, *Capitalization of Interest Cost*, as those costs are incurred by the other entity.

### **Amendment to Statement 32**

10. The reference to SOP 78-8, *Accounting for Product Financing Arrangements*, is deleted from Appendix A of Statement 32. The specialized accounting provisions of that SOP are superseded by this Statement.

### **Effective Date and Transition**

11. This Statement shall be applied prospectively to product financing arrangements entered into after June 15, 1981.

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| <p><b>The provisions of this Statement need<br/>not be applied to immaterial items.</b></p> |
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*This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:*

Donald J. Kirk, *Chairman*  
Frank E. Block  
John W. March  
Robert A. Morgan  
David Mosso  
Robert T. Sprouse  
Ralph E. Walters

## **Appendix A: BACKGROUND INFORMATION**

12. SOP 78-8 was developed to establish standards for product financing arrangements, such as transactions in which an enterprise sells and agrees to repurchase inventory (or substantially identical inventory) with the repurchase price equal to the original sale price plus carrying and financing costs. For example, an enterprise (sponsor) would sell a product and in a related transaction would agree to repurchase the product or processed goods of which the product was a component at a specified price over a specified period. The buyer, using the product and sometimes the financing arrangement as collateral, would borrow against the value of the product from a lending institution or other credit grantor and would remit the proceeds to the sponsor as payment for the product. As the terms of the financing arrangement were fulfilled by the sponsor, the buyer of the product would reduce its borrowing from the financial institution.

13. The following alternative accounting practices were being used when SOP 78-8 was issued: (a) product and obligations under product financing arrangements were reported as assets and liabilities in the sponsor's financial statements and (b) product and obligations under product financing arrangements were not reported as assets and liabilities in the sponsor's financial statements; instead, the obligations were disclosed as commitments. In addition, financing and holding costs incurred by the buyer often were not reported by the sponsor until the product was repurchased from the buyer.

14. The SOP concluded that (a) product financing arrangements, such as the one described in paragraph 12, did not transfer the risks and rewards of ownership of the product; (b) product financing arrangements are financing transactions rather than sales; and (c) a sponsor of an arrangement to finance product should account for the transaction as a borrowing rather than as a sale and, accordingly, should report the asset and related liability resulting from the arrangement on its balance sheet.

15. The Board has not undertaken a comprehensive reconsideration of the accounting issues discussed in SOP 78-8 and has extracted the specialized accounting and reporting principles without significant change. Accordingly, some of the background material and discussion of accounting alternatives have not been carried forward from the SOP. The Board's conceptual framework project on accounting recognition criteria will address criteria for recognizing a transaction as a sale that may pertain to the issues addressed in this Statement. A Statement of Financial Accounting Concepts resulting from that project in due course will serve as a basis for evaluating existing standards and practices. Accordingly, the Board may wish to evaluate the standards in this Statement when its conceptual framework project is completed.

## **Appendix B: SUMMARY OF CONSIDERATION OF COMMENTS ON EXPOSURE DRAFT**

16. An Exposure Draft of a proposed Statement, *Accounting for Product Financing Arrangements*, was issued February 9, 1981. The Board received 34 comment letters in response to the Exposure Draft. Certain of the comments received and the Board's consideration of them are discussed in this appendix.

17. In the Exposure Draft, the Board requested respondents to consider the implication of provisions of the proposed Statement on the accounting for certain contractor-subcontractor relationships, such as a contract in which specifications are provided by a customer for the manufacture of product. Some respondents indicated that the provisions of the proposed Statement were too broad and could result in certain contractor-subcontractor relationships, as well as purchase commitments, being accounted for inappropriately as product financing arrangements. They believe that the distinguishing characteristic of a product financing arrangement is that the sponsor retains the risks and rewards of ownership of the product while

the buyer merely holds the product for the sponsor. They stated that the purpose of a purchase commitment is to assure the supply of product, rather than to provide the financing for an entity's inventory, and should not be considered a product financing arrangement. They believe that a product financing arrangement does not exist if a supplier has the risks and rewards of ownership until the product is transferred to the sponsor. They also noted that in a typical contractor-subcontractor relationship, the purchase of product by a subcontractor on behalf of a contractor ordinarily leaves a significant portion of the subcontractor's obligation unfulfilled. The subcontractor has the risks of ownership of the product until it has met all the terms of a contract. Accordingly, they believe that the typical contractor-subcontractor relationship also should not be considered a product financing arrangement.

18. The Board believes that SOP 78-8 was intended to apply only to arrangements in which the sponsor is in substance the owner of the product and the other entity holds the product to facilitate a financing arrangement. The Board does not believe that SOP 78-8 was intended to apply to (a) ordinary purchase commitments in which the risks and rewards of ownership are retained by the seller (for example, a manufacturer or other supplier) until the product is transferred to a purchaser or (b) typical contractor-subcontractor relationships in which the contractor is not in substance the owner of product held by the subcontractor and the obligation of the contractor is contingent on substantial performance on the part of the subcontractor. Accordingly, the Board has modified paragraph 5(b) to indicate that this Statement applies only to product financing arrangements in which the payments that the other entity will receive are established by the financing arrangement and the amounts to be paid will be adjusted, as necessary, to cover substantially all fluctuations in purchasing and holding costs. Most purchase commitments do not have that characteristic because the supplier's profit could fluctuate if the supplier's costs of fulfilling the commitment, including holding costs, change before the commitment is fulfilled. Most contractor-subcontractor relationships, including those having cost-plus-fixed-fee provisions, are not product financing arrangements as contemplated in this Statement. Paragraph 5(a) states that in product financing arrangements "the specified prices are not subject to change except for fluctuations due to finance and holding costs." Paragraph 5(b) states that the ". . . amounts to be paid by the sponsor will be adjusted, as necessary, to cover substantially all fluctuations in costs incurred by the other entity in purchasing and holding the product. . . ." A cost-plus-fixed-fee contract typically provides for reimbursement of labor and other costs, not just finance and holding costs and, therefore, does not qualify as a product financing arrangement under paragraph 5(a). A fixed price contract typically is not adjusted to cover fluctuations in costs incurred by the subcontractor in purchasing and holding product and, therefore, does not qualify as a product financing arrangement under paragraph 5(b).

19. Some respondents suggested that arrangements involving the sale and repurchase of financial instruments be excluded from this Statement. The Board does not believe that SOP 78-8 was intended to encompass financial instruments as products. That conclusion is based, in part, on the existence of specialized accounting principles for agreements to sell and repurchase financial instruments in AICPA documents other than SOP 78-8. Accordingly, footnote 2 excludes financial instruments from the definition of product. In addition, footnote 2 carries

forward from SOP 78-8 without change the exclusion of unmined or unharvested natural resources.

20. Some respondents requested the Board to explain why the accounting for product financing arrangements specified by this Statement differs from the accounting for long-term unconditional purchase obligations (for example, take-or-pay contracts) specified by FASB Statement No. 47, *Disclosure of Long-Term Obligations*. They noted that this Statement requires a sponsor to recognize an asset and a liability for a product financing arrangement; Statement 47 requires disclosure, but not necessarily balance sheet recognition of an asset and a liability for an unconditional purchase obligation by a purchaser.

21. There are similarities between a sponsor's rights and obligations under a product financing arrangement and a purchaser's rights and obligations under an unconditional purchase obligation. Both the sponsor and the purchaser obtain probable future economic benefits from the assured source of product. Both are obligated to make future cash payments to the other party to the agreement. Beyond those similarities, however, there is a substantial difference in the related accounting issues.

22. The accounting issue with respect to an unconditional purchase obligation is whether at the time the contract is entered into the purchaser should report rights to receive future product or services as an asset and obligations to make future payments for product or services as a liability. Under a product financing arrangement, the product already exists and the other entity's purchase cost is known. The accounting issue addressed in this Statement is whether the sponsor should report the existing product currently held by the other entity as an asset and the obligation to pay the other entity as a liability. This Statement concludes that the sponsor is in substance the owner of the product and that the sponsor should, therefore, report the product as an asset and the related obligation as a liability. At the time a take-or-pay contract is entered into, by contrast, either the product does not yet exist (for example, electricity) or the product exists in a form unsuitable to the purchaser (for example, unmined coal); the purchaser has a right to receive future product but is not the substantive owner of existing product.

23. Some respondents questioned whether the absence of a reference in the Exposure Draft to the Addendum to Opinion 2 indicated that the Statement would apply to rate-regulated enterprises. The Board currently is considering the effect of rate regulation on regulated enterprises in another project. In the meantime, paragraph 7 was added to acknowledge that the provisions of the Addendum govern the application of this Statement to those operations of an enterprise that are regulated for rate-making purposes on a basis of individual company cost of service.

24. Several individual respondents suggested various substantive changes to the Exposure Draft. Adoption of those suggestions would have required a reconsideration of the provisions of SOP 78-8. Those suggestions were not adopted because such a reconsideration is beyond the scope of extracting the specialized accounting and reporting principles and practices from the

SOP and because none of the changes was broadly supported.

## **Appendix C: ILLUSTRATIONS OF THE APPLICATION OF THIS STATEMENT TO COMMON PRODUCT FINANCING ARRANGEMENTS**

25. This appendix illustrates how this Statement applies to two common product financing arrangements. The facts assumed in the examples are illustrative only and are not intended to modify or limit in any way the provisions of this Statement. The facts assumed in each case could vary in one or more respects without altering the application of the provisions of this Statement.

### **Example 1**

26. An enterprise (sponsor) sells a portion of its inventory to another entity (the entity through which the financing flows), and in a related transaction agrees to repurchase the inventory (paragraph 3(a)).

#### **Assumptions and Provisions of the Financing Arrangement**

27. The sponsor arranges for the other entity to acquire a portion of the sponsor's inventory. The other 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 other entity is guaranteed by the sponsor. The inventory is stored in a public warehouse during the holding period. The sponsor, in connection with the "sale" (legal title passes to the entity), enters into a financing arrangement under which:

- a. The sponsor agrees to pay all costs of the other entity associated with the inventory, including holding and storage costs.
- b. The sponsor agrees to pay the other entity interest on the purchase price of the inventory equivalent to the interest and fees incurred in connection with the bank financing.
- c. The sponsor agrees to repurchase the inventory from the other entity at a specified future date for the same price originally paid by the entity to purchase the inventory irrespective of changes in market prices during the holding period.
- d. The other 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.

#### **Application of the Provisions of This Statement**

28. In the product financing arrangement outlined above, both of the characteristics in paragraph 5 are present; accordingly, the sponsor neither records the transaction as a sale of inventory nor removes the inventory from its balance sheet. The sponsor recognizes a liability when the proceeds are received from the other entity. Financing and holding costs are accrued

by the sponsor as incurred by the other entity and accounted for in accordance with the sponsor's accounting policies for such costs. Interest costs are separately identified and accounted for in accordance with Statement 34.

## **Example 2**

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

### **Assumptions and Provisions of the Financing Arrangement**

30. The sponsor arranges for the other entity to purchase on its behalf an existing supply of fuel. In a related agreement, the sponsor agrees to purchase the fuel from the other entity over a specified period and at specified prices. The prices established are adequate to cover all financing and holding costs of the other entity. The other entity finances the purchase of fuel using the fuel and the agreement as collateral.

### **Application of the Provisions of This Statement**

31. In the product financing arrangement described above, both of the characteristics in paragraph 5 are present; accordingly, the sponsor reports the asset (fuel) and the related liability on its balance sheet when the fuel is acquired by the other entity. Financing and holding costs are accrued by the sponsor as incurred by the other entity and accounted for in accordance with the sponsor's accounting policies for financing and holding costs. Interest costs are separately identified and accounted for in accordance with Statement 34.

## Footnotes

FAS49, Footnote 1--The term *specialized* is used to refer to those accounting and reporting principles and practices in AICPA Guides and SOPs that are neither superseded by nor contained in Accounting Research Bulletins, APB Opinions, FASB Statements, or FASB Interpretations.

FAS49, Footnote 2--Unmined or unharvested natural resources and financial instruments are not considered to be a product for purposes of this Statement.

FAS49, Footnote 3--The characteristic described in paragraph 5(b) ordinarily is not present in purchase commitments or contractor-subcontractor relationships. (Refer to paragraph 18).