Statement of Financial Accounting Standards No. 47

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Disclosure of Long-Term Obligations

March 1981

Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 47: Disclosure of Long-Term Obligations

FAS 47 Summary

This Statement requires that an enterprise disclose its commitments under unconditional purchase obligations that are associated with suppliers' financing arrangements. Such obligations often are in the form of take-or-pay contracts and throughput contracts. This Statement also requires disclosure of future payments on long-term borrowings and redeemable stock. For long-term unconditional purchase obligations that are associated with suppliers' financing and are not recognized on purchasers' balance sheets, the disclosures include the nature of the obligation, the amount of the fixed and determinable obligation in the aggregate and for each of the next five years, a description of any portion of the obligation that is variable, and the purchases in each year for which an income statement is presented. For long-term unconditional purchase obligations that are associated with suppliers' financing and are recognized on purchasers' balance sheets, payments for each of the next five years shall be disclosed. For long-term borrowings and redeemable stock, the disclosures include maturities and sinking fund requirements (if any) for each of the next five years and redemption requirements for each of the next five years, respectively.

INTRODUCTION

1. The Board has received requests to consider the subjects of accounting for **project financing arrangements** [1] and accounting for **take-or-pay contracts**, **throughput contracts**, and other unconditional purchase obligations typically associated with project financing arrangements. Some have stated that certain of those arrangements and contracts result in acquisitions of ownership interests and obligations to make future cash payments that should be recognized as assets and liabilities on participants' balance sheets. Others consider such arrangements and contracts to result in commitments or contingent liabilities that should not be recognized on balance sheets.

2. The Board currently has on its agenda three topics that are part of the conceptual framework for financial accounting and reporting and that pertain to those requests:

a. Accounting recognition criteria for elements, which will address the types of transactions, events, and circumstances that should lead to recognition in financial statements of items that qualify as assets, liabilities, revenues, expenses, etc., under the definitions of elements of financial statements [2]
b. Measurement of the elements of financial statements, which will consider how assets, liabilities, and other elements should be measured
c. Funds flows, liquidity, and financial flexibility, which will determine the kinds of information that should be reported to facilitate assessments of an enterprise's flow of funds, liquidity, and ability to obtain cash to adapt to unexpected difficulties or opportunities

The Board believes that the questions raised in paragraph 1 can be addressed more readily after further work is completed on some or all of those conceptual framework projects.

3. The arrangements and contracts discussed in paragraph 1 and in the remainder of this Statement are sometimes recognized on balance sheets. If they are not recognized on balance sheets, they often are disclosed in the notes to financial statements. If disclosed, the disclosure sometimes quantifies the enterprise's rights and obligations. As an interim measure, pending further work on those conceptual framework projects identified in paragraph 2, the Board has concluded that unconditional purchase obligations associated with financing arrangements should be disclosed and quantified. The Board also has concluded that enterprises should disclose future cash payments in a manner similar to existing disclosures of capital lease obligations for long-term borrowings and capital stock with mandatory redemption requirements. This Statement provides standards of disclosure.

4. Appendix A provides additional background information and the basis for the Board's conclusions. Appendix C illustrates applications of this Statement.

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

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Definition and Scope

6. An unconditional purchase obligation is an obligation to transfer funds in the future for fixed or minimum amounts or quantities of goods or services at fixed or minimum prices (for example, as in take-or-pay contracts or throughput contracts). An unconditional purchase obligation that has all of the following characteristics shall be disclosed in accordance with paragraph 7 (if not recorded on the purchaser's balance sheet) or in accordance with paragraph

10(a) (if recorded on the purchaser's balance sheet):

a. Is noncancelable, or cancelable only
   (1) Upon the occurrence of some remote contingency or
   (2) With the permission of the other party or
   (3) If a replacement agreement is signed between the same parties or
   (4) Upon payment of a penalty in an amount such that continuation of the agreement appears reasonably assured
b. Was negotiated as part of arranging financing for the facilities that will provide the contracted goods or services or for costs related to those goods or services (for example, carrying costs for contracted goods)
c. Has a remaining term in excess of one year

Future minimum lease payments under leases that have those characteristics need not be disclosed in accordance with this Statement if they are disclosed in accordance with FASB Statement No. 13, *Accounting for Leases.*

Unrecorded Obligations

7. A purchaser shall disclose unconditional purchase obligations that meet the criteria of paragraph 6 and that have not been recognized on its balance sheet. The disclosures shall include:

a. The nature and term of the obligation(s)
b. The amount of the fixed and determinable portion of the obligation(s) as of the date of the latest balance sheet presented in the aggregate and, if determinable, for each of the five succeeding fiscal years (paragraph 8)
c. The nature of any variable components of the obligation(s)
d. The amounts purchased under the obligation(s) (for example, the take-or-pay or throughput contract) for each period for which an income statement is presented

Disclosures of similar or related unconditional purchase obligations may be combined. These disclosures may be omitted only if the aggregate commitment for all such obligations not disclosed is immaterial.

8. Disclosure of the amount of imputed interest necessary to reduce the unconditional purchase obligation(s) to present value is encouraged but not required. The discount rate shall be the effective initial interest rate of the borrowings that financed the facility (or facilities) that will provide the contracted goods or services, if known by the purchaser. If not, the discount rate shall be the **purchaser's incremental borrowing rate** at the date the obligation is entered into.

Recorded Obligations and Redeemable Stock

9. Certain unconditional purchase obligations are presently recorded as liabilities on purchasers' balance sheets with the related assets also recognized. This Statement does not alter that accounting treatment or the treatment of future unconditional purchase obligations that are substantially the same as those obligations already recorded as liabilities with related assets, nor does it suggest that disclosure is an appropriate substitute for accounting recognition if the substance of an arrangement is the acquisition of an asset and incurrence of a liability.

10. The following information shall be disclosed for each of the five years following the date of the latest balance sheet presented:

a. The aggregate amount of payments for unconditional purchase obligations that meet the criteria of paragraph 6 and that have been recognized on the purchaser's balance sheet
b. The combined aggregate amount of maturities and sinking fund requirements for all long-term borrowings
c. The amount of redemption requirements for all issues of capital stock that are redeemable at fixed or determinable prices on fixed or determinable dates, separately by issue or combined.

Effective Date and Transition

11. This Statement shall be effective for financial statements for fiscal years ending after June 15, 1981. Earlier application is encouraged. The disclosures required by paragraph 7(d) need not be included in financial statements for periods beginning before the effective date of this Statement that are being presented for comparative purposes with financial statements for periods after the effective date.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Morgan dissented.

Mr. Morgan dissents to issuance of this Statement because he believes it is not needed. In his opinion, conscientious preparers and auditors will disclose the existence of unconditional purchase obligations associated with financing arrangements if there is a reasonable possibility that a payment will be required without the purchaser receiving an asset of comparable value in return. Such disclosure seems to be required by FASB Statement No. 5, *Accounting for Contingencies;* if Statement 5 is ambiguous in that regard, an Interpretation would be sufficient. Mr. Morgan does not believe that there is a need for specific disclosure requirements for unconditional purchase obligations associated with financing arrangements, particularly if there is only a remote possibility that payment will be required without the purchaser receiving an asset of comparable value in return. Also, Mr. Morgan believes that the disclosure of obligations for each of the next five years may convey a notion of a contractual period longer than is realistic. He believes that such agreements are renegotiated frequently in practice.

Mr. Morgan also disagrees with mandating disclosure of next-five-year repayment requirements on long-term borrowings and redemption requirements on redeemable stock. He does not recall any requests to the Board to consider such disclosures.

Mr. Morgan's preference would be to delay action on this Statement until completion of the Board's conceptual framework project on accounting recognition criteria. That project could provide the Board a basis to conclude that unconditional purchase obligations should be recorded on the balance sheet, disclosed in the notes to financial statements, or both.

The 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 AND BASIS FOR CONCLUSIONS

12. As noted in the introduction, the FASB was asked to consider accounting for project financing arrangements. The particular requests related to whether the unconditional purchase obligations and indirect guarantees of indebtedness of others typical of project financing arrangements result in participants acquiring ownership interests and obligations to make future cash payments that should be recognized as assets and liabilities on their balance sheets. The Board concluded, as noted in paragraph 2, that those accounting questions could be answered better after further progress is made on the conceptual framework for financial accounting and reporting.

13. Paragraphs 40 and 41 of FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* state one objective of financial reporting:

> Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change resources and claims to those

> resources. . . .
>
> Financial reporting should provide information about an enterprise's economic resources, obligations, and owners' equity. That information helps investors, creditors, and others identify the enterprise's financial strengths and weaknesses and assess its liquidity and solvency. Information about resources, obligations, and owners' equity also provides. . . direct indications. . . of the cash needed to satisfy many, if not most, obligations. . . . Many obligations are direct causes of cash payments by the enterprise, and reasonably reliable measures of. . . future net cash outflows are often possible for those. . . obligations.

Existing accounting for and disclosure of unconditional purchase obligations associated with financing arrangements are inconsistent among enterprises and often fail to satisfy that objective of financial reporting. In addition, as noted in paragraph 1, the unconditional purchase obligations discussed in this Statement have some of the characteristics of liabilities. Accordingly, as an interim measure pending a decision on whether the obligations should be recognized on purchasers' balance sheets, the Board decided that disclosures of unconditional purchase obligations associated with financing arrangements should be expanded and standardized to satisfy that objective of financial reporting.

14. On March 31, 1980, the FASB released an Exposure Draft, *Disclosure of Guarantees, Project Financing Arrangements, and Other Similar Obligations* (March Exposure Draft). The FASB received 102 letters of comment on the March Exposure Draft. Based on the comments received, the content of the March Exposure Draft was separated into two documents that were exposed concurrently for comment on November 14, 1980: a revised Exposure Draft, *Disclosure of Unconditional Obligations,* and a proposed Interpretation*, Disclosure of Indirect Guarantees of Indebtedness of Others.*

15. The Board received 67 letters of comment on the revised Exposure Draft. Certain of the comments received and the Board's consideration of them are discussed in paragraphs 16-22.

16. Some respondents stated that the revised Exposure Draft did not distinguish clearly between the unconditional obligations that would have been required to be disclosed and the unconditional obligations that would have been excluded. The distinction between long-term purchase commitments and take-or-pay contracts was of particular concern. Other respondents suggested that the Board should limit the disclosures to unconditional obligations with clear financing elements. Based on those comments, the Board reconsidered the scope of this Statement. The Board's accounting recognition criteria project will consider criteria for balance sheet recognition of all contractual rights and obligations, whether or not unconditional and whether or not associated with financing arrangements. With respect to most contractual rights and obligations, the Board believes existing disclosures are adequate until the fundamental accounting concepts are resolved. Unconditional purchase obligations associated with financing arrangements, however, have many similarities to borrowings and to lease obligations, and the Board believes that existing disclosures often fail to adequately inform readers of the

significance of those obligations. Accordingly, this Statement establishes standards of disclosure for unconditional purchase obligations associated with financing arrangements.

17. Some expressed concern that this Statement might impose on purchasers a burden of determining whether a supplier has used an unconditional purchase obligation to arrange financing without the purchaser's direct involvement or knowledge. The Board believes that, for most arrangements covered by this Statement, financing considerations are an integral part of negotiating the terms of the unconditional purchase obligation. There is no intent to require a purchaser to investigate whether a supplier used an unconditional purchase obligation to help secure financing, if the purchaser would otherwise be unaware of that fact.

18. Some respondents believe that FASB Statement No. 5, *Accounting for Contingencies,* already provides for adequate disclosure of unconditional purchase obligations associated with financing arrangements. They state that quantification of the obligation should be required only if a loss under the contract is reasonably possible. As stated in paragraph 13, however, the Board believes that existing disclosures of unconditional purchase obligations often fail to provide adequate information about an enterprise's economic resources and claims to those resources. Statement 5 contains requirements pertaining to accounting for and reporting loss contingencies, but does not otherwise address long-term unconditional obligations that are not required to be disclosed as loss contingencies but that nevertheless impose significant future financial commitments for which cash must be available.

19. Some respondents stated that the disclosures required by this Statement might be misleading to readers of financial statements because the obligations are disclosed but the associated benefits are not disclosed. Some respondents described the approach of the revised Exposure Draft as a liquidation perspective rather than a going-concern approach. The Board has not included explicit requirements to disclose associated benefits because the expected benefits may be difficult to quantify and may not be assured of realization. Paragraph 7(a) of this Statement requires a description of the nature of the obligation, and each of the first three illustrations in Appendix C describes the obligation and the associated benefit (access to processing facilities, availability of needed pipeline capacity, and an assured supply of ammonia, respectively). The lack of explicit requirements to disclose associated benefits does not preclude an enterprise from describing those benefits.

20. Several respondents noted that the requirements in Statement 13 to disclose future lease obligations apply to leases with initial or remaining terms in excess of one year and suggested conforming the requirements in this Statement. The Board has adopted that suggestion both to conform with Statement 13 and to reduce the costs of applying this Statement by eliminating the need to review short-term unconditional purchase obligations.

21. The revised Exposure Draft and this Statement require quantification of the fixed and determinable portion of unrecorded purchase obligations and description, but not quantification, of the variable portion of unrecorded obligations. Several respondents noted that the variable

portion is similar to contingent rentals on leases. They suggested that the purchases made in each period for which an income statement is presented should be disclosed, similar to the disclosure of contingent rental expense, to help readers of financial statements estimate future payments under the variable portions. The Board adopted that suggestion.

22. Paragraphs 7 and 10(a) of this Statement require purchasers to disclose future payments under long-term unconditional purchase obligations associated with financing arrangements, and Statement 13 requires lessees to disclose future payments under capital and operating leases. The Board believes it would be anomalous to require those disclosures but not to require disclosures of maturities and sinking fund requirements on long-term borrowings and of mandatory redemption requirements on capital stock that are similarly relevant in assessing future cash requirements. This Statement, therefore, includes standards of disclosure pertaining to long-term borrowings and capital stock with mandatory redemption features. Those standards are substantially the same as disclosures currently required by Regulation S-X of the Securities and Exchange Commission for publicly held enterprises.

Appendix B: GLOSSARY

23. For purposes of this Statement, certain terms are defined as follows:

a. *Project financing arrangement.* The financing of a major capital project in which the lender looks principally to the cash flows and earnings of the project as the source of funds for repayment and to the assets of the project as collateral for the loan. The general credit of the project entity is usually not a significant factor, either because the entity is a corporation without other assets or because the financing is without direct recourse to the owner(s) of the entity.

b. *Purchaser's incremental borrowing rate.* The rate that, at the inception of an unconditional purchase obligation, the purchaser would have incurred to borrow over a similar term the funds necessary to discharge the obligation.

c. *Take-or-pay contract.* An agreement between a purchaser and a seller that provides for the purchaser to pay specified amounts periodically in return for products or services. The purchaser must make specified minimum payments even if it does not take delivery of the contracted products or services.

d. *Throughput contract.* An agreement between a shipper (processor) and the owner of a transportation facility (such as an oil or natural gas pipeline or a ship) or a manufacturing facility that provides for the shipper (processor) to pay specified amounts periodically in return for the transportation (processing) of a product. The shipper (processor) is obligated to provide specified minimum quantities to be transported (processed) in each period and is required to make cash payments even if it does not provide the contracted quantities.

Appendix C: ILLUSTRATIONS OF THE APPLICATION OF THIS STATEMENT TO COMMON ARRANGEMENTS

Example 1

24. B Company has entered into a throughput agreement with a manufacturing plant providing that B will submit specified quantities of a chemical (representing a portion of plant capacity) for processing through the plant each period while the debt used to finance the plant remains outstanding. B's processing charges are intended to be sufficient to cover a proportional share of fixed and variable operating expenses and debt service of the plant. If, however, the processing charges do not cover such operating expenses and debt service, B must advance additional funds to cover a specified percentage of operating expenses and debt service. Such additional funds are considered advance payments for future throughput.

25. B's unconditional obligation to pay a specified percentage of the plant's fixed operating expenses and debt service is fixed and determinable, while the amount of variable operating expenses that B is obligated to pay will vary depending on plant operations and economic conditions.

26. B's disclosure might be as follows:

> To secure access to facilities to process chemical X, the company has signed a processing agreement with a chemical company allowing B Company to submit 100,000 tons for processing annually for 20 years. Under the terms of the agreement, B Company may be required to advance funds against future processing charges if the chemical company is unable to meet its financial obligations. The aggregate amount of required payments at December 31, 19X1 is as follows (in thousands):

19X2	$ 10,000
19X3	10,000
19X4	9,000
19X5	8,000
19X6	8,000
Later years	100,000
Total	145,000
Less: Amount representing interest	(45,000)
Total at present value	$100,000

In addition, the company is required to pay a proportional share of the variable operating expenses of the plant. The company's total processing charges under the agreement in each of the past 3 years have been $12 million.

Example 2

27. C Company has entered into a throughput agreement with a natural gas pipeline providing that C will provide specified quantities of natural gas (representing a portion of capacity) for transportation through the pipeline each period while the debt used to finance the pipeline remains outstanding. The tariff approved by the Federal Energy Regulatory Commission contains two portions, a demand charge and a commodity charge. The demand charge is computed to cover debt service, depreciation, and certain expected expenses. The commodity charge is intended to cover other expenses and provide a return on the pipeline company's investment. C Company must pay the demand charge based on the contracted quantity regardless of actual quantities shipped, while the commodity charge is applied to actual quantities shipped. Accordingly, the demand charge multiplied by the contracted quantity represents a fixed and determinable payment.

28. C's disclosure might be as follows:

C Company has signed an agreement providing for the availability of needed pipeline transportation capacity through 1990. Under that agreement, the company must make specified minimum payments monthly. The aggregate amount of such required payments at December 31, 19X1 is as follows (in thousands):

19X2	$ 5,000
19X3	5,000
19X4	5,000
19X5	4,000
19X6	4,000
Later years	26,000
Total	49,000
Less: Amount representing interest	(9,000)
Total at present value	$40,000

In addition, the company is required to pay additional amounts depending on actual quantities shipped under the agreement. The company's total payments under the agreement were (in thousands) $6,000 in 19W9 and $5,500 both in 19X0 and in 19X1.

Example 3

29. A subsidiary of F Company has entered into a take-or-pay contract with an ammonia plant. F's subsidiary is obligated to purchase 50 percent of the planned capacity production of the plant each period while the debt used to finance the plant remains outstanding. The monthly payment equals the sum of 50 percent of raw material costs, operating expenses, depreciation, interest on the debt used to finance the plant, and a return on the owner's equity investment.

30. F's disclosure might be as follows:

> To assure a long-term supply, one of the company's subsidiaries has contracted to purchase half the output of an ammonia plant through the year 2005 and to make minimum annual payments as follows, whether or not it is able to take delivery (in thousands):

19X2 through 19X6 ($6,000 per annum)	$ 30,000
Later years	120,000
Total	150,000
Less: Amount representing interest	(65,000)
Total at present value	$ 85,000

> In addition, the subsidiary must reimburse the owner of the plant for a proportional share of raw material costs and operating expenses of the plant. The subsidiary's total purchases under the agreement were (in thousands) $7,000, $7,100, and $7,200 in 19W9, 19X0, and 19X1, respectively.

Example 4

31. D Company has outstanding two long-term borrowings and one issue of preferred stock with mandatory redemption requirements. The first borrowing is a $100 million sinking fund debenture with annual sinking fund payments of $10 million in 19X2, 19X3, and 19X4, $15 million in 19X5 and 19X6, and $20 million in 19X7 and 19X8. The second borrowing is a $50 million note due in 19X5. The $30 million issue of preferred stock requires a 5 percent annual cumulative sinking fund payment of $1.5 million until retired.

32. D's disclosure might be as follows:

Maturities and sinking fund requirements on long-term debt and sinking fund requirements on preferred stock subject to mandatory redemption are as follows (in thousands):

	Long-term debt	**Preferred stock**
19X2	$10,000	$1,500
19X3	10,000	1,500
19X4	10,000	1,500
19X5	65,000	1,500
19X6	15,000	1,500

Footnotes

FAS47, Footnote 1--Terms defined in the glossary (Appendix B) are in **boldface type** the first time they appear in this Statement.

FAS47, Footnote 2--The question of when rights and obligations that arise under contracts should be recognized as assets and liabilities in financial statements is addressed in an FASB Research Report, *Recognition of Contractual Rights and Obligations,* prepared by Professor Yuji Ijiri of Carnegie-Mellon University as part of the accounting recognition criteria project. The Research Report discusses several possible recognition points, including initiation of the contract, delivery of the contracted goods or services, and payment for those goods or services.