

Component: Consolidation / SPE's (SIC 12)

Short title: Accounting for tolling arrangements

Issue

It is common in the metals industry that a principal company subcontracts the production of metals from raw materials. The principal company may often utilize all of the capacity of a subcontractor. It may establish the subcontractor or have contractual terms such that it controls the subcontractor.

Arrangements as described above are often referred to as tolling arrangements. The principal company delivers raw materials (for example, alumina) to toll manufacturers (such as aluminium smelters) without transferring ownership of the raw material or finished product. The toll manufacturer does not sell finished goods, but receives a manufacturing fee from the principal.

What are the accounting consequences for the principal?

Solution

Generally, tolling arrangements should be accounted for simply as service contracts. However, the substance of the relationship between the principal company and the toll manufacturer may indicate that the toll manufacturer is controlled by the principal company. The consolidation of the toll manufacturer by the principal company is required in these circumstances [SIC 12].

The following circumstances, for example, may indicate a relationship in which the principal company controls the toll manufacturer and consequently should consolidate the toll manufacturer:

- a) in substance, the activities of the toll manufacturer are being conducted on behalf of the principal company according to its specific business needs so that the enterprise obtains benefits from the toll manufacturer's operation;
- b) in substance, the principal company has the decision-making powers to obtain the majority of the benefits of the activities of the toll manufacturer or, by setting up an "autopilot" mechanism, the principal company has delegated these decision making powers;
- c) in substance, the principal company has rights to obtain the majority of the benefits of the toll manufacturer and therefore may be exposed to risks incident to the activities of the toll manufacturer; or
- d) in substance, the principal company retains the majority of the residual or ownership risks related to the toll manufacturer or its assets in order to obtain benefits from its activities.