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Technical Accounting Alert

Debt factoring and invoice discounting

Introduction

This alert discusses the main issues to be addressed in determining when debt factoring transactions result in:

- de-recognition of the underlying receivables; or
- continuing recognition of the receivables; or
- partial de-recognition of the receivables.

as well as guidance on the appropriate accounting treatment in each case.

Note

In this IFRS alert the term "debt factoring" is used as a general term to describe arrangements involving a transfer of rights to cash flows from trade receivables. Other terms are sometimes used to describe this type of arrangement, such as "invoice discounting". Also, terminology differs from one jurisdiction to another.

Relevant Australian Standards

References in this TA alert are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 39 Financial Instruments: Recognition and Measurement	AASB 139 Financial Instruments: Recognition and Measurement

Overview

Debt factoring and invoice discounting (in general terms "factoring") are widely used to provide a source of finance, to offer protection against bad debt and/or for sales ledger administration. The terms of factoring transactions differ extensively. Common features include:

- the transferor entity receives cash up front in exchange for rights to cash collected from its receivables;
- legal title to the receivables might or might not be transferred (more often not);
- the rights transferred are often subject to restrictions or guarantees;
- the transferee may have recourse back to the transferor. These rights can be up to a set limit, or to the full extent of non-performance;

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- the transferee might administer the sales ledger, undertake credit control, send invoices and statements and undertake other servicing activities;
- the debtors might pay the transferee directly, pay into a designated bank account over which the transferee has some control or pay the entity;
- the arrangement is often "rolling" ie all new invoices raised are factored until the arrangement is discontinued; and
- the transferee charges interest and fees.

Under a factoring arrangement control is passed to the factor who manages all aspects of the sales ledger. Invoices might be marked as assigned and payment made to the factor (which some businesses find unattractive). In an invoice discounting arrangement, the business continues to receive customers' payments, manage its own sales ledger and credit control activities. The invoice discounter might advance, for example, 80% of invoice value and remit the balance, less interest and fees, when a customer pays.

These transactions need to be analysed to determine whether or not the underlying receivables should be de-recognised in accordance with IAS 39. This is important because the accounting consequences can be significant. Broadly speaking, de-recognition accounting is similar to recording a sale of the receivables. Failing to meet the de-recognition tests results in accounting for the amount advanced by the factoring entity as a financial liability.

IAS 39's requirements on de-recognition are complex and require interpretation in a number of areas. These requirements were introduced to address sophisticated financial transactions such as securitisations, but also apply to more straightforward arrangements such as debt factoring. The requirements are intended in large part to ensure that financing arrangements are not kept "off statement of financial position" inappropriately.

Although this is a complex area, in most factoring arrangements it is relatively straightforward to determine whether or not de-recognition is appropriate. Factoring arrangements are often referred to as "with recourse" or "without recourse". In a "with recourse" arrangement, all or most of the credit risk remains with the entity. Such an arrangement will almost always fail the risks and rewards tests (and possibly others). It should therefore be accounted for as a loan.

By contrast, a "without recourse" arrangement transfers all or most of the credit risk to the factor (transferee). Such an arrangement is likely to qualify for de-recognition (subject to an evaluation of other risks that might be relevant such as slow payment risk). In substance, such an arrangement could be economically similar to a sale of the receivables in which case it is accounted for accordingly.

The continuing involvement accounting requirements of IAS 39 will rarely apply in most factoring arrangements because most arrangements result in substantially all the risks and rewards being either transferred or retained. These requirements include special rules on recording and measuring continuing involvement assets and liabilities that deviate from the normal requirements of IAS 39.

Detailed guidance

When an entity factors its trade receivables, an analysis should be carried out to determine whether or not the receivables should be "de-recognised" (ie removed from the entity's statement of financial position). This analysis should be based on the entire arrangement, including any guarantees or other recourse arrangements.

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An **unconditional** sale of receivables will result in de-recognition because all the risks and rewards are transferred (IAS 39.AG39(a)). However, most factoring arrangements do not involve an unconditional sale. When this occurs, IAS 39's more detailed requirements on de-recognition of financial assets need to be applied.

These requirements are set out in IAS 39.15 to 37 and the associated Application Guidance. The requirements are also summarised in a flowchart in IAS 39.AG36.

Most debt factoring arrangements involve transferring rights associated with more than one receivable. In these cases, the first step in analysing an arrangement for de-recognition is to determine whether the de-recognition tests should be applied to each receivable individually or to the entire portfolio. The tests should be applied to the entire portfolio when the portfolio comprises "a group of similar assets" (IAS 39.16). In our view, a group of trade receivables is normally a group of similar assets for this purpose.

In summary, a factoring arrangement will result in de-recognition when:

- it is a "qualifying transfer"; **and**
- it results in substantially all the risks and rewards being transferred to the transferee.

These two issues are considered further below.

Is the arrangement a "qualifying transfer"?

A debt factoring arrangement can only result in de-recognition if it qualifies as a transfer in accordance with either IAS 39.18(a) or (b) (ie if it is a "qualifying transfer"). A transfer is a qualifying transfer if:

- the contractual rights to the cash flows are transferred; or
- the contractual rights to the cash flows are retained but the entity assumes an obligation to pay them on to the transferee in a manner that meets the so-called IAS 39.19 "pass-through tests" - see below.

The IASB has indicated that a transfer of the contractual rights to the cash flows need not necessarily involve transferring legal title to the underlying assets. This "test" will also be met if the entity transfers rights to **all** the cash flows, whilst retaining legal title. However, the pass-through tests should be applied to arrangements that do not involve transferring all the contractual rights to the cash flows (see IASB Update September 2006).

The IAS 39.19 "pass-through" conditions are that:

- the entity has no obligation to pay any amounts to the transferee unless it receives the cash flows from the customers; and
- the entity can not sell or pledge the receivables to a third party; and
- the entity has to remit the cash flows it collects without material delay.

The existence of guarantees, options that allow the transferee to transfer receivables back to the entity and other recourse arrangements are likely to conflict with the condition in the first bullet point above. Such arrangements will often therefore cause the pass-through tests to be "failed".

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If the arrangement qualifies as a transfer, an analysis should be made of the extent to which it transfers the risks and rewards to the transferee.

Have substantially all of the risks and rewards of ownership been transferred?

A qualifying transfer will result in de-recognition when substantially all the risks and rewards are transferred (IAS 39.20(a)). If the entity **retains** substantially all the risks and rewards, it should continue to recognise the receivables (IAS 39.20(b)).

If the entity neither transfers nor retains substantially all the risks and rewards of ownership, the entity must evaluate whether it has retained control. If it has **not** retained control, it derecognises the assets and recognises any new assets/liabilities created. If the entity retains control, it continues to recognise the assets to the extent of its continuing involvement in them (IAS 39.20(c)).

In evaluating the extent to which risks and rewards are transferred or retained, risks and rewards that are reasonably expected to be significant in practice should be considered. In a portfolio of short term receivables, the most significant risk is usually **credit risk** ie the risk that the customer will default. Hence the outcome of an evaluation of risks and rewards will often depend on which party assumes the risk of **reasonably possible credit losses**. An arrangement that involves the transferee having full recourse to the transferor for credit losses will "fail" the risks and rewards tests. An arrangement in which the transferee has no recourse to the transferor for credit losses will generally "pass" the risks and rewards tests.

With longer term receivables (including receivables from customers that are expected to be slow to pay) **interest rate risk and slow payment risk** might also become significant. An arrangement in which the entity continues to pay interest to the transferee until the underlying debtor settles involves the transferee retaining the risk of slow payment. The significance of this risk should be evaluated in the context of the overall arrangement.

We consider that **dispute risk** is not generally relevant to the analysis. This is because a dispute (eg a dispute over whether the contracted goods or services have been delivered in accordance with the customer contract) concerns the existence of the asset rather than its risks and rewards.

Control

As noted above, the "control test" is applied only when the risks and rewards test indicates that the entity neither transfers nor retains substantially all the risks and rewards of ownership. The key determinant of control is whether or not the transferee has the **practical ability to sell the receivable** (IAS 39.AG42).

When the transferee has this practical ability, control is considered to be transferred. If not, control is considered to be retained. This evaluation depends on the contractual arrangements in each case. However, the transferee will generally only be in a position to sell an asset if it has legal title to that asset (assuming the asset is not traded in an active market). In some jurisdictions and arrangements, legal title to the receivables usually remains with the entity (often because the underlying debt contracts cannot be transferred without the consent of the debtors). In these cases the transferor retains control. In other jurisdictions the transfer of legal title is more straightforward and is therefore more common.

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Consequences of de-recognition

If the arrangement results in de-recognition of the receivables:

- the difference between the carrying amount and the consideration received is recognised in the statement of comprehensive income;
- in the case of assets included in the "available-for-sale" category, any gain or loss previously recorded in equity is recycled to the statement of comprehensive income (this will not normally apply in a debt factoring arrangement as the underlying assets are usually included in the "loans and receivables" category);
- if the entity retains servicing obligations in respect of the assets (which is not normally the case in a debt factoring arrangement), an asset or liability should be recognised - see below (IAS 39.25).

Consequences of failing de-recognition

If the arrangement does not result in de-recognition of the receivables:

- the entity continues to recognise the receivables in its statement of financial position until settled and applies the normal IAS 39 measurement rules (including impairment reviews if applicable) (IAS 39.29);
- the proceeds received are recorded as a liability, recognised at fair value less any transaction costs incurred. The liability is subsequently measured at amortised cost using the effective interest method (IAS 39.29);
- if the transferee services the receivables, a servicing expense should be recognised as incurred.

Consequences of partial de-recognition (continuing involvement)

The IAS 39 requirements on continuing involvement accounting are particularly complex. This guidance focuses on continuing involvement in the form of a guarantee issued by the entity to the transferee as part of the factoring arrangement. A guarantee may lead to continuing involvement accounting when its effect, combined with the other terms of the arrangement, is that the transferee has assumed some but not substantially all of the risk of reasonably possible credit losses. In this case:

- the entity partially de-recognises the receivables but continues to recognise an amount to the extent of its continuing involvement (ie an ongoing exposure to the assets concerned). When continuing involvement is in the form of a guarantee or similar, the amount of this new continuing involvement asset is the lower of (i) the amount of the receivables transferred and; (ii) the guarantee amount (IAS 39.30(a));
- an associated liability is recognised. The liability equals the **sum** of the guarantee amount **and** the fair value of the guarantee (IAS 39.AG48(a));
- the fair value element of the guarantee liability is subsequently recognised in the statement of comprehensive income on a time proportion basis or the amount that would be recognised in accordance with IAS 37 if applicable and if higher (IAS 39.47(c) and AG48(a));
- the continuing involvement asset and corresponding amount of the guarantee liability are reduced in unison as and when the amount that could become payable under the guarantee reduces to less than the guarantee amount.

Examples

Example 1 - Invoice discounting

Entity A agrees with factoring company B to enter into an invoice discounting arrangement. Under the terms of the arrangement, the factoring company B agrees to advance to entity A 85% of the face value of receivables from specified customers, with a face value of $ 100,000. Entity A will continue to manage its own sales ledger. Customers are instructed to pay the amounts owed into a bank account controlled by the factoring company B. As customers pay, factoring company B deducts its charges for fees and interest and remits the remaining amount to A. If total receipts from customers are less than $ 85,000, the factoring company has no recourse to company A.

Expected credit losses from the receivables included in the arrangement are 5% of face value and losses of up to 10% are considered reasonably possible.

Analysis

It is evident with only a limited analysis that this arrangement will not result in de-recognition of the receivables. Entity A retains all significant credit risks; factoring company B is exposed to losses only if they exceed 15%, which is more than the reasonably possible amount of losses.

In this example, the arrangement may not even represent a qualifying transfer of the receivables for the purpose of IAS 39.18. This is because (i) legal ownership is not transferred to B; and (ii) the rights transferred are not equivalent to legal ownership. The IAS 39.18(a) test is therefore failed. Further, the arrangement does not involve a transfer of the cash flows from the assets, since the factoring company remits back to Entity A the amount collected less a variable amount for fees and interest charges.

It might be argued that an analysis could be undertaken on the basis of a transfer of 85% of the cash flows, as IAS 39.16(b) requires application of the de-recognition tests to part of an asset when a pro-rata share of the cash flows is transferred. However, in this case the amount ultimately retained by the factor is not a pro rata share of the cash flows.

Entity A should therefore continue to recognise the receivables until settled. The amounts advanced will be recognised as a financial liability.

Example 2 - Debt factoring with recourse

Entity C agrees with factoring company D to enter into a debt factoring arrangement. Under the terms of the arrangement, the factoring company B agrees to pay $ 91,500, less a servicing charge of $ 1,500 (net proceeds of $ 90,000), in exchange for 100% of the cash flows from specified local currency short-term receivables. The receivables have a face value of $ 100,000. Factoring company D assumes the management of the sales ledger, and the customers will be instructed to pay the amounts owed into a bank account of the factoring company. Entity C also writes a guarantee to the factoring company under which it will reimburse any credit losses in excess of $ 5,000. Expected credit losses from the receivables included in the arrangement are $ 5,000 and losses of up to $ 15,000 are considered reasonably possible. The guarantee is estimated to have a fair value of $ 500.

Immediately before the transaction, the carrying value of the receivables was $ 95,000. Entity C does not discount its trade receivables on the grounds that it regards the effect of discounting as immaterial (see IAS 39.AG79).

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Analysis

This is a "qualifying transfer" for the purposes of IAS 39.18(a), since the transferee has acquired rights to 100% of the cash flows. We consider that this arrangement therefore involves a transfer of rights equivalent to legal ownership.

The next step is to consider the extent to which the overall arrangement transfers substantially all the risks and rewards of ownership to factoring company D. In this example, the receivables are short-term and denominated in local currency. The most significant risk is therefore credit risk. Slow payment risk might also be significant but the effect of the fixed fee arrangement is that the entity transfers this risk to the factoring company. The effect of the guarantee is that the transferor (Entity C) retains 100% of the risk that credit losses will exceed the expected amount. The main "reward" is that credit losses will be less than the expected amount. It could therefore be argued that Entity C has neither transferred nor retained substantially all the risks and rewards of ownership. However, given that the downside risk is in this case more than the upside and that no downside risk is transferred, on balance our view is that the arrangement does not qualify for de-recognition.

As a result, Entity C should:

- continue to recognise the receivables;
- record the consideration received as a liability. In this case, the gross consideration of $ 91,500 is partly for the rights to the cash flows (the "loan element"), partly for the guarantee. It should be allocated between the two elements;
- the deduction for servicing can be dealt with in two different ways. One approach is to treat this as a prepayment and write it off over the period in which services are provided. The other is to treat the $ 1,500 as a transaction cost, deduct it from the initial liability amount and (in effect) recognise the expense as part of the effective interest expense. The second approach is more straightforward and is adopted in this example;
- account for the loan element at amortised cost using the EIR method. The loan repayments are not known or fixed - they are equal to the receipts from the debtors. Hence the initial carrying amount of the loan and subsequent amortised cost calculations are estimated based on the expected timing and amounts of the cash flows from the receivables;
- account for the guarantee in accordance with IAS 39.47(c).

At the beginning of the arrangement, Entity C records the following entries:

Initial accounting ($)	Debit	Credit
Cash	90,000	
Financial liability		89,500
Guarantee liability		500

Assuming the cash flows from the receivables are exactly as expected (ie $ 95,000), the loan repayments will correspond to this amount. Interest expense of $ 5,500 ($ 95,000 less $ 89,500) will be recognised over the life of the arrangement. The guarantee liability will be amortised to zero over the same period. The entries will be:

Subsequent accounting ($)	Debit	Credit
Trade receivables		95,000
Financial liability	89,500	
Interest expense - statement of comprehensive income	5,500	
Guarantee liability	500	
Amortisation of guarantee - statement of comprehensive income		500

Example 3 - Debt factoring without recourse

Facts remain as in Example 2, except that Entity C does **not** write a guarantee to debt factoring company D.

Analysis

In the absence of any recourse arrangement, the substance of this transaction is straightforward sale of the receivables. The entry recorded is:

Initial accounting ($)	Debit	Credit
Cash	90,000	
Receivables		95,000
Loss on de-recognition	5,000	

Example 4 - Debt factoring with partial recourse

Facts remain as in Example 2, except that the guarantee is for losses in excess of $ 5,000 but payments under the guarantee are also capped at $ 5,000. The guarantee is estimated to have a fair value of $ 500.

Analysis

This arrangement leaves both parties exposed to reasonably possible credit losses, since the debt factoring company is exposed to losses in excess of $ 10,000 and losses of up to $ 15,000 are considered reasonably possible. Entity C therefore neither transfers nor retains substantially all the risks and rewards of ownership. Continuing involvement accounting is required.

Entity C therefore:

- partially de-recognises the receivables but recognises a continuing involvement asset. In the case of a guarantee, this corresponds to the amount of the consideration it could be required to repay ie the guarantee amount ($ 5,000) - IAS 39.30(a);
- recognises a liability corresponding to the guarantee amount plus the fair value of the guarantee - IAS 39.AG48(a);
- recognises a gain or loss on partial de-recognition.

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Initial accounting ($)	Debit	Credit
Cash	90,000	
Receivables		95,000
Continuing involvement asset	5,000	
Continuing involvement liability		5,000
Guarantee liability		500
Loss on partial de-recognition - statement of comprehensive income	5,500	

Subsequently, Entity C:

- retains the continuing involvement asset and liability until the amount which it could be required to repay is reduced to less than $ 5,000 (as a result of payments from the debtors, exercise of the guarantee if applicable and eventual expiry of the arrangement); and
- accounts for the guarantee in accordance with IAS 39.47(c).

Assuming the cash flows from the receivables are as expected ($ 95,000), Entity C's continuing involvement will be reduced to zero. The guarantee liability will be amortised to zero over the repayment period, which will need to be estimated in many cases. The entries will be:

Subsequent accounting ($)	Debit	Credit
Continuing involvement asset		5,000
Continuing involvement liability	5,000	
Guarantee liability	500	
Amortisation of guarantee - statement of comprehensive income		500

Note

On November 12 2009, the IASB published IFRS 9 Financial Instruments (IFRS 9). IFRS 9 addresses the classification and measurement of financial assets. The publication of IFRS 9 represents the completion of Phase 1 of IASB's project to replace IAS 30. However, at this stage IFRS 9 only addresses the classification and measurement of financial assets. Financial liabilities therefore continue to be accounted for in accordance with IAS 30. Work has begun on phases 2 and 3 of the project which addresses impairment and hedge accounting, respectively. Also, a separate project is underway to replace IAS 39's requirements on derecognition.

IFRS 9 WAS ISSUED IN AUSTRALIA AS AASB 9 FINANCIAL INSTRUMENTS WITH AN EFFECTIVE DATE OF 1 JANUARY 2013 AND THEREFORE AASB 9 REQUIREMENTS HAVE NOT BEEN CONSIDERED FOR THE PURPOSE OF THIS ALERT.

Further Information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au