

Datum: 2005 06 16
Unser Zeichen: RoR
Ihr Ansprechpartner: Roman Rohatschek

Factoring under IAS/IFRS

In your engagement letter dated January 18th, 2005, we were asked to issue our expert opinion on factoring under IAS/IFRS covering the following issues:

- How is Factoring seen from the point of view of a customer/client of a factoring company?
- How is Factoring seen from the point of view of a factoring company?
- Accounting treatment.

The following opinion is based on the regulation of IFRS as of July 2005. These rules are applicable to annual periods beginning on or after January 1st, 2005.

The IFRS themselves do not mention “factoring”, there is only one example of the sale of a short-term receivable given in IAS 39, Appendix A, AG 40.e. Therefore, the opinion is based on the general rules covering the recognition and derecognition of financial assets.

Note on terminology: for easier identification of the parties referred to in this study, the following terms are used:

- Factor: the financial institution offering the factoring service.
- Seller: the client or customer of the factor.
- Buyer: the debtor or client’s customer.

How is Factoring seen from the point of view of a customer/client of a factoring company?

Decision to Derecognise the Receivable

From the point of view of the seller, the important question is, if and at what point of time the receivable has to be derecognized from the financial statements.

Derecognition of financial assets is regulated in IAS 39.15-39.37. In connection with a factoring agreement, the following issues have to be proved:

1. Does the seller transfer the receivable to the factoring bank? (IAS 39.18a, 18b)
2. Has the seller either transferred or retained substantially all risks and rewards? (IAS 39.20a, b)
3. Has the seller retained control of the receivable? (IAS 39.20c)

1) Transfer of the Receivable

The seller transfers the receivable if, and only if, it either transfers the contractual rights to receive the cash flows of the receivable or retains the contractual rights to receive the cash flows of the receivable, but assumes a contractual obligation to pay the cash flows to the factor (pass-through arrangement).

If this condition is not met, the seller is not allowed to derecognise the receivable from the balance sheet. To meet the condition of a pass-through arrangement, it is important that the seller:

- has no obligation to pay amounts to the factor unless it collects equivalent amounts from the original asset. Short-term advances to the seller with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.
- is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as a collateral to the factoring company for the obligation to pay them cash flows.
- has an obligation to remit any cash flows it collects on behalf of the factor without material delay. In addition, the seller is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents during the short settlement period from the collection date to the date of required remittance to the factor, and interest earned on such investments is passed to the factor.

2) Transfer of substantially all Risks and Rewards

If the seller transfers substantially all the risks and rewards of ownership of the receivable, the seller shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

If the seller retains substantially all the risks and rewards of ownership of the receivable, the seller shall continue to recognise the financial asset.

The main risk of ownership of short term receivables is the credit risk. Therefore, in case of a factoring without recourse, substantially all the risks are transferred, whereas in case of a factoring with full recourse, substantially all the risks are retained by the seller.

In the case of export factoring of receivables in foreign currency, there is the foreign exchange risk in addition to the credit risk. As long as there is no prepayment of the factor, the full foreign exchange risk is

assumed by the seller. In the case of a prepayment, there is usually an agreement that the foreign exchange risk is borne by the seller.

In case that the seller neither transfers nor retains substantially all of the risk, which could happen in case of a factoring of receivable in foreign currency without recourse and no prepayment of 100%, question #3 is decisive.

3) Retain of Control of the Receivable

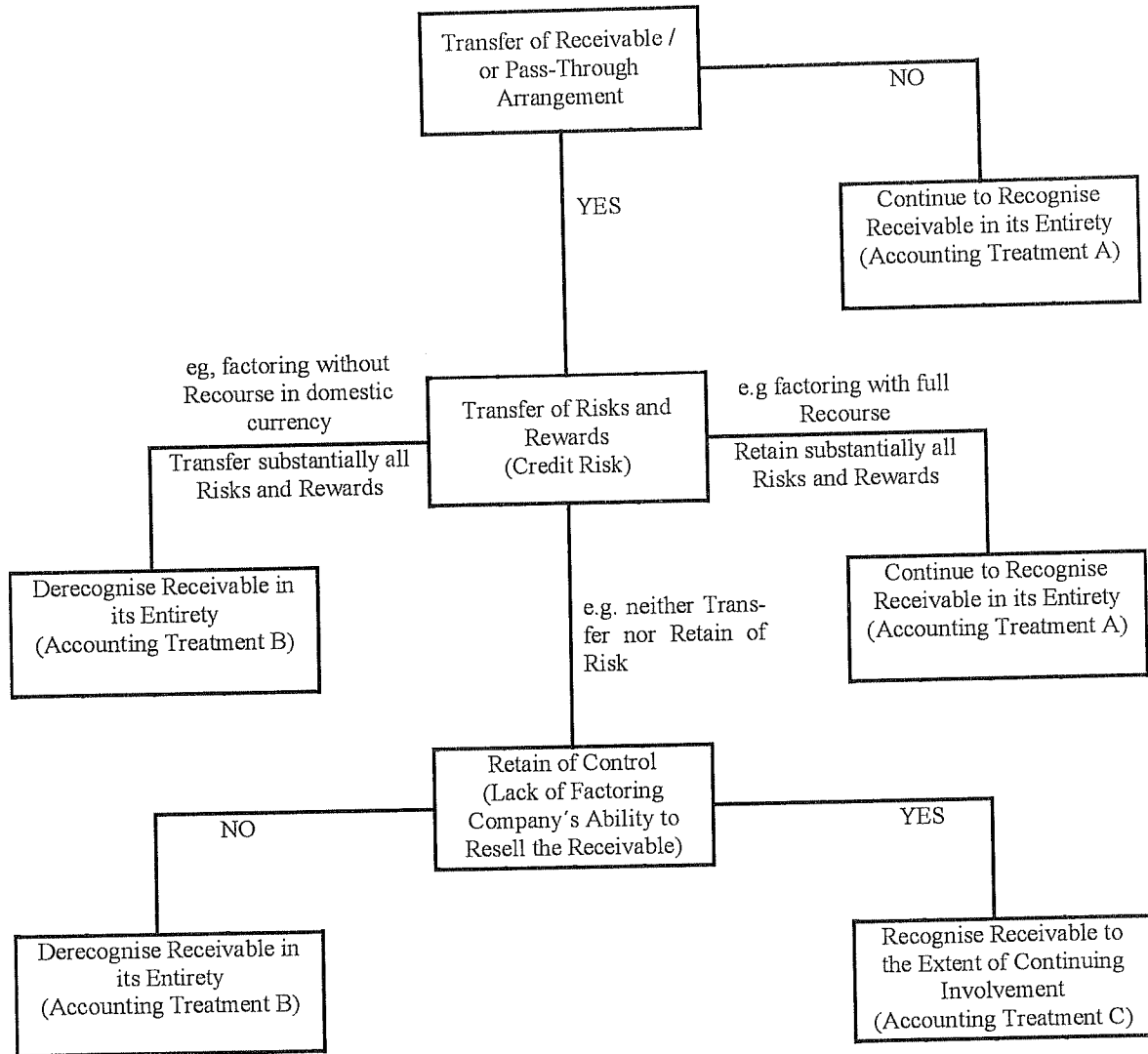
The retain of control is only important if the seller neither transfers nor retains substantially all the risks and rewards of ownership of the receivable.

Whether the seller has retained control of the transferred receivable depends on the factor's ability to sell the receivable. If the factor has the practical ability to sell the receivable in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the seller has not retained control. In all other cases, the seller has retained control.

If the seller has not retained control, it shall derecognise the receivable and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

If the seller has retained control, it shall continue to recognise the receivable to the extent of its continuing involvement in the financial asset.

The following chart illustrates the evaluation of whether and to what extent a financial asset is derecognised:



Accounting Treatment

A) Continue to Recognise Receivable in its Entirety

If the seller has to continue to recognise the receivable in its entirety, the seller has to recognise a financial liability for the price (consideration) received from the factor. This financial liability must not be offset with the receivable. Similarly, any income or expense from the financial liability must not be offset with expense or income from the receivable (Example 1).

B) Derecognise Receivable in its Entirety

On derecognition of a financial asset in its entirety, the receivable against the debtor is replaced with the receivable against the factor. Any difference between the carrying amount and the sum of the price (consideration) received (including any new asset obtained less any new liability assumed) shall be recognised in profit or loss (Example 2)¹.

If the seller retains any rights or obligations on the transferred receivable or if the transfer results in the seller obtaining new financial assets or assuming a new financial liability, the factoring customer has to recognise a new financial asset, or a new financial liability, at fair value.

In the case of invoice discounting without recourse, the seller transfers substantially all the risks and rewards of the assets to the factor, but continues to perform the collection management as an agent for the factor. If the seller has to perform future services for the factor, for which the fair value can be quantified, [g – I would argue the servicing liability would have to be quantified under the Standard as it assumes this will be reliably measurable] a servicing liability has to be recognised by the seller (IAS 39.24).² The initial fair value of the servicing asset or liability is offset with the profit or loss on derecognition of the receivable (Example 3).

C) Recognise Receivable to the Extent of Continuing Involvement

The extent of the seller's continuing involvement in the transferred receivable is the extent to which it is exposed to changes in the value of the transferred receivable. For example, when the seller's continuing involvement takes the form of guaranteeing (part of) the credit risk of the transferred receivable, the extent of the seller's continuing involvement is the lower of the amount of the receivable and the maximum amount of the consideration received that the seller could be required to repay ('the guarantee amount') – (Example 5).

When the seller continues to recognise an asset to the extent of its continuing involvement, the seller also has to recognise an associated liability.

¹ In the rare case of a cumulative gain or loss that had been recognised directly in equity, this cumulative gain or loss shall be recognised in profit or loss.

² It should be noted that IAS 39 contains an assumption that the fair value of such services can be measured reliably.

Disclosure

If the seller has either transferred a receivable or entered into the factoring arrangement in such a way that the arrangement does not qualify as a transfer of the receivable and if the seller either continues to recognise all of the receivable (*Accounting Treatment A*) or continues to recognise the receivable to the extent of the entity's continuing involvement (*Accounting Treatment C*), it shall disclose for all involved receivables (IAS 32.94):

- the nature of the assets;
- the nature of the risks and rewards of ownership to which the seller remains exposed;
- when the seller continues to recognise all of the asset, the carrying amounts of the asset and of the associated liability; and
- when the seller continues to recognise the asset to the extent of its continuing involvement, the total amount of the asset, the amount of the asset that the seller continues to recognise and the carrying amount of the associated liability.

How is Factoring seen from the point of view of a factoring company?

Factoring Arrangements for the Factoring Company

If the seller retains the contractual rights to receive the cash flows of the receivable and has no obligation to remit any cash flow it collects on behalf of the factor without material delay, then the factor has a receivable from the seller rather than the buyer.³

In the case that the seller transfers the rights to receive the cash flows of the receivable or in the case of a pass-through arrangement, there are the following possibilities for the factor:

1) Factoring without recourse

In the case of factoring without recourse, the factor becomes has to recognise the original receivable in the balance sheet, because substantially all risks and rewards have been transferred. The factor measures this receivable initially at fair value, ie the consideration paid to the seller. If a part of the consideration is to be paid later on, the total consideration would be recognised as the fair value of the receivable, in addition, a liability against the seller is recognised.

2) Guarantee or Risk Sharing Agreement

If substantially all of the credit risk is neither transferred nor retained by the seller, because the seller guarantees for a part of the receivable, the factor has all the same one sole receivable. The fact that the guarantee exists, is taken into account when measuring the fair value of the receivable, ie both the financial status of the debtor and the financial status of the seller have to be considered. If the debtor defaults, the receivable against the debtor is changed into a receivable against the seller up to the amount of the guarantee (Example 5).

3) Factoring with recourse

In case of factoring with recourse, the collection risk remains with the seller. Therefore, the factor has a receivable against the seller, not against the buyer. The factor measures this receivable initially at fair value, ie the consideration paid to the seller. If a part of the consideration is to be paid later on, this liability is to be setoff with the receivable, in case the conditions of IAS 32.42 are met. If the debtor pays the open amount to the factor directly, the factor has to reduce the receivable against the seller. The receivable against the seller is measured with regard to the default risk of the seller (Example 1).

The same accounting treatment would be exercised, if the receivable is not transferred at all or the seller has no obligation to pass the cash flow from the receivable directly to the factor.

³ In addition, the other conditions of a pass-through arrangement have to be met; see page 2: Transfer of the receivable.

Initial Measurement

The financial asset has to be measured initially at its fair value, ie the fair value of the price (consideration) paid to the seller (plus the fair value of any assumed obligation minus the fair value of any additionally received rights).⁴

The book value or nominal value of the seller's receivable is not relevant.

Subsequent Measurement

The value of financial assets arising from factoring - ie either the original receivable against the debtor or a receivable against the seller – will basically change due to the credit risk and the foreign exchange risk:

- Measurements in the carrying value caused by foreign exchange rates have to be recognised through profit or loss, irrespective of the classification (IAS 21.28)
- Where an asset is considered to be impaired, the impairment rule within IAS 39 should be applied.

Impairment:

Objective evidence that a financial asset is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events (IAS 39.59):

- significant financial difficulty of the issuer or obligor;
- a breach of contract, such as a default or delinquency in interest or principal payments;
- the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
- it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for that financial asset because of financial difficulties; or
- observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
 - adverse changes in the payment status of borrowers in the group (eg an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or
 - national or local economic conditions that correlate with defaults on the assets in the group (eg an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

⁴ In case of a financial asset classified as held for trading or at fair value through profit or loss, transaction costs are not added to fair value upon initial measurement, in case of a financial asset classified available for sale or loan and receivable, transaction costs have to be added.

Classification of Financial Asset

The factoring contract results in an financial assets for the factor, either in an receivable against the seller (if the original receivable is not transferred) or in an receivable against the debtor (if the receivable is transferred).

In both cases, the factor has three possibilities to classify the financial asset upon initial recognition.⁵

- The financial asset may be designated as available for sale
- If the asset is neither designated as at fair value through profit or loss nor as available for sale, it is classified as loan and receivable.

In case that the factoring contract is entered for the purpose of selling the financial asset in the near future, the asset has to be classified as held for trading, which is a sub classification of at fair value through profit or loss.

However, in the case of factoring the classification has little impact on the subsequent measurement as foreign exchange differences as well changes caused by objective evidence of impairment are always recognised in profit or loss.

Only in the case of a fair value change due to other reasons (eg if the fair value of a long-term receivable changes due to changes in the market interest rate) the classification is important:

- A gain or loss on a financial asset classified as at fair value through profit or loss or held-for-trading shall be recognised in profit or loss.
- A gain or loss on an available-for-sale financial asset shall be recognised directly in equity, through the statement of changes in equity. An impairment and the reversal of an impairment of an available-for-sale financial asset are recognised in profit or loss.
- Loans and Receivables are carried at amortised cost. Thus, changes in fair value are recognised in profit or loss only when the loan and receivable is impaired.

⁵ Under the restrictive conditions of IAS 39.9 , the receivable might as well be classified as at fair value through profit or loss.

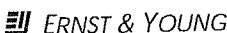
Revenue Recognition

The revenue of the factoring company consists of an interest income and an income for services. For the revenue recognition in IFRS-statements, these two parts have to be split.

- The interest income is recognised pro-rata-temporis using the effective interest method (IAS 18.30)
- Commission income shall be recognised by reference to the stage of completion of the transaction at the balance sheet date, if the outcome of the transaction can be estimated reliably. (IAS 18.20)

In case of the services performed by a factoring company, it seems not very likely to fulfil the requirements for a reliable estimate, in particular because the factoring company does not perform single transactions for a certain customer, but is involved in an ongoing business. Therefore, the revenue from the rendering of services should be recognised at completion of the service or, if there is an ongoing business with a customer, pro-rata-temporis.

with kind regards,

 ERNST & YOUNG
WIRTSCHAFTSPRÜFUNGSGESELLSCHAFT MBH

Appendix

Example 1 – Factoring with Recourse

Fact Pattern

The seller transfers a receivable in domestic currency to the factor. The seller guarantees the existence and – in addition – the collection of the receivable.

The receivable has a face value and book value of 100. The factor will pay the face value of 100; in addition, a factoring fee of 2 will be charged.

Conclusion

As substantially all risks and rewards are retained by the seller, the seller has to continue to recognise the receivable in its entirety.

The receivable against the factor and the liability to transfer the receivable can be measured at settlement date, ie the receivable against the factor is not shown in addition to the sales receivable.

The receivable against the debtor is replaced by a receivable against the factor, which is recognised with the fair value of 100. As the seller gets no future services, the factoring fee is expensed immediately and can be offset with the receivable against the factor.

Book entries of seller at date of assignment (trade date):

| | Debit | Credit |
|--------------------------|-------|--------|
| Factoring Fee Expense | 2 | |
| Other Liability (Factor) | | 2 |

Book entries of seller at date of collection by the factor (settlement date):

| | Debit | Credit |
|--------------------------|-------|--------|
| Cash | 98 | |
| Other Liability (Factor) | 2 | |
| Sales Receivable | | 100 |

As the collection risk remains with the seller, the factor has no receivable against the debtor. At the time of collection, a liability of 100 against the seller arises. With the collection, the service of the factor is finished and the factoring fee is recognised as revenue; the receivable of the fee can be offset with the liability:

Book entries of factor at collection date:

| | Debit | Credit |
|--------------------|-------|--------|
| Cash | 100 | |
| Liability (Seller) | | 98 |
| Factoring Revenue | | 2 |

If the factor pays the 100 to the seller before the collection from the debtor, the factor recognises a receivable against the seller. This receivable is measured at fair value, ie the consideration of 100 paid.

Book entries of factor in case of an advance:

| | Debit | Credit |
|---------------------------|-------|--------|
| Other Receivable (Seller) | 100 | |
| Cash | | 100 |

Example 2 – Factoring without Recourse

Fact Pattern

The seller transfers a receivable in domestic currency to the factor. The seller guarantees the existence of the receivable, but in case of the debtor's default, the factor will bear the loss.

The receivable has a face value and book value of 100. The factor will pay the face value of 100; in addition, a factoring fee of 5 will be charged.

Conclusion

As substantially all risks and rewards are transferred to the factor, the seller has to derecognise the receivable in its entirety. The receivable against the debtor is replaced by a receivable against the factor, which is recognised with the fair value of 100. As the seller gets no future services, the factoring fee is expensed immediately and can be offset with the receivable against the factor, if the conditions of IAS 32.42 are met.

Book entries of seller at assignment date:

| | Debit | Credit |
|---------------------------|-------|--------|
| Other Receivable (factor) | 95 | |
| Factoring Fee Expense | 5 | |
| Sales Receivable | | 100 |

As the collection risk is transferred to the factor, the factor becomes the creditor of the original receivable, which he recognizes at fair value, ie the consideration of 100 paid.

Book entries of factor at assignment date:

| | Debit | Credit |
|---------------------|-------|--------|
| Receivable (Debtor) | 100 | |
| Liability (Seller) | | 100 |

With the collection, the service of the factor is finished and the factoring fee is recognised as revenue:

Book entries of factor at collection date:

| | Debit | Credit |
|---------------------|-------|--------|
| Cash | 100 | |
| Receivable (Debtor) | | 100 |
| Liability (Seller) | 100 | |
| Cash | | 95 |
| Factoring Revenue | | 5 |

Example 3 – Factoring without Recourse, Invoice Discounting

Fact Pattern

The seller transfers a receivable in domestic currency to the factor. The seller guarantees the existence of the receivable, but in case of the debtor's default, the factor will bear the loss. In addition, the seller continues to perform the collection management as an agent for the factor.

The receivable has a face value and book value of 100. The factor will pay the face value of 100; in addition, a factoring fee of 2 will be charged.

Conclusion

As substantially all risks and rewards are transferred to the factor, the seller has to derecognise the receivable in its entirety. The receivable against the debtor is replaced by a receivable against the factor, which is recognised with the fair value of 100. As the seller gets no future services, the factoring fee is expensed immediately and can be offset with the receivable against the factor if the conditions of IAS 32.42 are met.

However, the seller has to perform a future service – the collection management - for the factor. If the fair value of this can be quantified – eg at the amount of 3 – a servicing liability has to be recognised.

Book entries of seller at assignment date::

| | Debit | Credit |
|---------------------------|-------|--------|
| Other Receivable (factor) | 98 | |
| Factoring Fee Expense | 2 | |
| Servicing Expense | 3 | |
| Sales Receivable | | 100 |
| Servicing Liability | | 3 |

For the factor, the accounting treatment at the agreement date is the same as in example 2:

Book entries of factor at assignment date:

| | Debit | Credit |
|---------------------|-------|--------|
| Receivable (Debtor) | 100 | |
| Liability (Seller) | | 100 |

If the fair value of the collection service can be quantified, the servicing expense and the factoring revenue are recognized separately:

Book entries of factor at collection date:

| | Debit | Credit |
|---------------------|-------|--------|
| Cash | 100 | |
| Receivable (Debtor) | | 100 |
| Service Expense | 3 | |
| Liability (Seller) | 100 | |
| Cash | | 98 |
| Factoring Revenue | | 5 |

Example 4 – Factoring without Recourse; Foreign Currency

Fact Pattern

The seller transfers a receivable in foreign currency to the factor. The seller guarantees the existence of the receivable, but in case of the debtor's default, the factor will bear the loss.

There is no advance payment by the factor, ie the factor pays the seller after collection of the receivable.

The receivable has a face value and book value of 100. The factor will pay the face value of 100; in addition, a factoring fee of 5 will be charged.

Conclusion

The collection risk is transferred to the factor, but the foreign exchange risk remains with the seller. Therefore, the seller can derecognise the receivable in its entirety only if the he does not retain control, ie if the factor can resell or pledge the receivable without the seller's permission.

If this is the case, the accounting treatment is the same as in Example 2.

Book entries of seller as assignment date:

| | Debit | Credit |
|---------------------------|-------|--------|
| Other Receivable (factor) | 95 | |
| Factoring Fee Expense | 5 | |
| Sales Receivable | | 100 |

Book entries of factor at assignment date:

| | Debit | Credit |
|---------------------|-------|--------|
| Receivable (Debtor) | 100 | |
| Liability (Seller) | | 100 |

Book entries of factor at collection date:

| | Debit | Credit |
|---------------------|-------|--------|
| Cash | 100 | |
| Receivable (Debtor) | | 100 |
| Liability (Seller) | 100 | |
| Cash | | 95 |
| Factoring Revenue | | 5 |

Example 5 – Risk Sharing Agreement

Fact Pattern

The seller sells a short-term receivable to the factor. If the debtor defaults, the factoring customer has a deductible of 20, the rest of the collection risk is taken by the factoring company. The factoring company is not allowed to sell or pledge the receivable.

The receivable has a face value and book value of 100. The factor will pay the face value of 100; in addition, a factoring fee of 2 will be charged.

Conclusion

As the collection risk is neither completely transferred to the factor, nor completely retained by the seller, and as the seller retains control, the seller has to recognize the receivable to the extent of continuing involvement. The maximum payment for the seller is the deductible of 20. Therefore, the seller has to recognize the sales receivable with 20 and a liability against the factor with 20, which can be set off with the receivable against the factor.

The factoring fee of 2 is recognized as expense.

Book entries of seller at assignment date:

| | Debit | Credit |
|---------------------------|-------|--------|
| Other Receivable (factor) | 78 | |
| Factoring Fee Expense | 2 | |
| Sales Receivable | | 80 |

In case of an advance by the factor to the seller (payment of 98 cash), a liability of 20 against the factor is shown:

Book entries of seller at date of prepayment:

| | Debit | Credit |
|---------------------------|-------|--------|
| Cash | 98 | |
| Liability (Factor) | | 20 |
| Other Receivable (factor) | | 78 |

The factor has to recognize a receivable measured at fair value, ie the consideration of 100 paid. There is no difference to the treatment in example 2.

Book entries of factor at assignment date:

| | Debit | Credit |
|---------------------|-------|--------|
| Receivable (Debtor) | 100 | |
| Liability (Seller) | | 100 |

Book entries of factor at collection date:

| | Debit | Credit |
|---------------------|-------|--------|
| Cash | 100 | |
| Receivable (Debtor) | | 100 |
| Liability (Seller) | 100 | |
| Cash | | 98 |
| Factoring Revenue | | 2 |

In the case of a default of the debtor, the factor will pay the seller 78 (100 – 20 deductible – 2 factoring fee)

Book entries of seller at assignment date:

| | Debit | Credit |
|------------------|-------|--------|
| Cash | 78 | |
| Other Receivable | | 78 |
| Bad Debt Expense | 20 | |
| Sales Receivable | | 20 |

Book entries of factor at collection date:

| | Debit | Credit |
|---------------------|-------|--------|
| Liability Seller | 100 | |
| Cash | | 78 |
| Receivable (Debtor) | | 20 |
| Factoring Revenue | | 2 |
| Bad Debt Expense | 80 | |
| Receivable (Debtor) | | 80 |