



HAL
open science

Toward an understanding of the IAS 39 derecognition principles: An application to the factoring transactions' reporting

Lionel Escaffre, Olivier J. Ramond

► **To cite this version:**

Lionel Escaffre, Olivier J. Ramond. Toward an understanding of the IAS 39 derecognition principles: An application to the factoring transactions' reporting. EUFIN Workshop on Accounting in Europe, Sep 2007, Cergy Pontoise, France. hal-00769383

HAL Id: hal-00769383

<https://hal.science/hal-00769383>

Submitted on 31 Dec 2012

HAL is a multi-disciplinary open access archive for the deposit and dissemination of scientific research documents, whether they are published or not. The documents may come from teaching and research institutions in France or abroad, or from public or private research centers.

L'archive ouverte pluridisciplinaire **HAL**, est destinée au dépôt et à la diffusion de documents scientifiques de niveau recherche, publiés ou non, émanant des établissements d'enseignement et de recherche français ou étrangers, des laboratoires publics ou privés.

A Research Note:
Toward an understanding of
the IAS 39 derecognition principles:

An application to the factoring transactions' reporting

Abstract: A recent report issued by the US-based audit company Ernst & Young (2006) stated that, in 2005, 23 out of the 39 French CAC 40 index companies initiated assets transfers. More specifically, 6 companies operated as transferee while 32 as assignor. Those transactions were mainly concerned with securitization and credit factoring issues. Besides, in 69% of the assets transfer cases, the companies did not derecognize the credit assets and only half of the listed firms under scrutiny provided additional disclosure regarding these operations. Similar observations can be made in other European continental countries (*see* Escaffre and Ramond, 2007; IFRIC, 2006a). This result highlights the current heterogeneity around the accounting treatment related to financial asset derecognition under international accounting standards and more specifically under IAS 39. Although IAS 39 contends that a financial asset derecognition should imply the transfer of both its contractual rights and most of its inherent risks to a counterparty, it fails to provide any readily-applicable models or methodologies necessary to meet these two criteria. Adopting the perspective from a credit factoring transaction ruled by civil code-based provisions, this paper aims to shed into light the potential current ambiguity and technicality surrounding the IAS 39 day-to-day application. For doing so, it first presents the IAS 39 derecognition features and then through a simple setting-based example discuss the (de)recognition of a credit assets transfer under IFRS while underlining some institutional perspectives for future standard interpretations.

Keywords: Credit Assets, Credit Factoring, Financial Instruments Derecognition, Inherent Risk and Rewards, Contractual Rights, IAS 39

Lionel Escaffre
University of Angers
LARGO
13, Allée François Mitterrand – BP 13633
49036 ANGERS cedex 01
lionel.escaffre@free.fr

Olivier Ramond
Paris-Dauphine University
CEREG
Place du Maréchal de Lattre de Tassigny
75016 PARIS
olivier.ramond@dauphine.fr

1. Introduction

The IAS 39 standard is undoubtedly one of the lynchpins of the international accounting standards framework (Gray, 2003; Walton, 2006). Although much of its underlying discussions and debates have focused on the generalized use of the fair value concept and its implementation through the financial instruments-based transactions reporting (Walton, 2004), many concerns have been raised regarding the practical uneasiness and ambiguity of the IAS 39 underlying principles (see Hague, 2004). An epitome of this day-to-day application hardness in a reporting process remains the accounting treatment of credit assets factoring transactions that intends to translate the operations made between a financial entity (i.e. a factor) and a company willing to outsource or turn into cash its credit assets. In this respect, a recent report issued by the US-based audit company Ernst & Young (2006) stated that, in 2005, 23 out of the 39 French CAC 40 index companies initiated assets transfers. More specifically, 6 companies operated as transferee while 32 as assignor. Those transactions were mainly concerned with securitization and credit factoring issues. Besides, in 69% of the assets transfer cases, the companies did not derecognize the credit assets and only half of the listed firms under scrutiny provided additional disclosure regarding these operations. Similar observations can be made in other European continental countries (*see* Escaffre and Ramond, 2007; IFRIC, 2006a). This result highlights the current heterogeneity around the accounting treatment related to financial asset derecognition under international accounting standards and more specifically under IAS 39. Although this standard contends that a financial asset derecognition should imply the transfer of both its contractual rights and most of its inherent risks to a counterparty, it fails to provide any readily-applicable models or methodologies necessary to meet of these two criteria. Adopting the perspective from a credit factoring transaction ruled by civil code-based provisions, this paper aims to shed into light the potential current ambiguity and technicality surrounding the IAS 39 day-to-day application. For doing so, it presents the IAS 39 derecognition features and through a simple setting-based example discuss the (de)recognition of a credit assets transfer under IFRS while underlining some institutional perspectives for future standard interpretations.

At a European level, factor entities are compulsory called to report their activity operations under international GAAPs if directly listed on a capital market or being subsidiary of a quoted company. Symmetrically, companies operating factoring transactions with a financial institution must also translate into their financial statements these assets transfer operations. However, international accounting standards (including IAS 39 *Financial Instruments:*

Recognition and Measurement) unlike most of the continental accounting standards (especially latin-based GAAPs) do not explicitly discuss this particular financial transactions pattern. Subsequently, grounded principles, such as the substance over form principle, coming from the IASB conceptual framework (§35) should guide and be fulfilled by financial preparers through the reporting process: “[...] *The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an enterprise may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the enterprise continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction)*”.

In addition to this fundamental principle, IAS 39 (*see* IAS 39.15 to 37) and its application guidance (AG.36) could let think that credit assets factoring are likely to be a “non-operation” under international GAAPs. However, on the other side, credit assets factoring are common practice in Europe.

Adopting a practical perspective, the IAS 39 standard (from paragraph 17 to 23) makes this credit assets transfer notion explicit while enforcing companies reporting under IAS / IFRS to examine successively the transfer of the:

- Contractual rights of the credit asset’s cash flows,
- Risk and rewards related to the credit assets’ ownership,
- Credit assets’ retained control.

A quantitative approach of the cash flows is also privileged by the standard through the concept of significant variability. The analysis of a credit assets transfer must then rely on a statistical analysis and economic cash flow and the transferred risks.

Consequently, if these criteria of derecognition are not confirmed, the credit assets transfer must be re-qualified under “loan warranted by a credit assets portfolio”. Under this latter assumption, the factor would then be assimilated to a banker that finances a loan.

Under international law, factoring transactions are ruled by the Ottawa convention¹ which states that (art. 1^{er}a.) « *the provider can or must transfer its credit assets to the transferee...* ».

¹ Unidroit Convention of the 28th May of 1988.

This convention put much emphasis on the civil code position that classically defines the factoring operations as “commercial credit assets transfer from its owner to a factor entity”.

Under IFRS, there then exists a significant divergence between the accounting and law perspectives overall because the international accounting standards require the appreciation of the economic substance of each transfer operation and do not base its analysis on any ownership statement. Regarding this application issues, the IFRIC² committee, originally aimed to provide with IFRS interpretations, have been asked for making the conditions of a credit asset derecognition more precise. The main issue relies on two aspects that could be summed up by two questions:

- Under what conditions should it be considered that assets are similar for the application of the derecognition test and should be then grouped up for the implementation of this test?
- What conditions should we apply to the « pass through » contract notion defined by IAS 39.19³?

Following the various comments received, the IFRIC committee decided in January 2007 to actively work on an interpretation that is still under much scrutiny.

Using the French setting as a legal benchmark for the treatment of credit assets factoring transactions and in the absence of any interpretative text of the provisions made by IAS 39, this article proposes to discuss certain rules of management for the reporting of factoring operations based on the criteria of derecognition proposed by the IAS framework. The French capital market environment is used here since the French legal auditors association (Compagnie Nationale des Commissaires aux Comptes – CNCC) did not manage to reach a clear consensus on this treatment under IAS / IFRS. As a result, the CNCC invites each

² International Financial Reporting Interpretations Committee.

³ IAS 39.19. When an entity retains the contractual rights to receive the cash flows of a financial asset (the ‘original asset’), but assumes a contractual obligation to pay those cash flows to one or more entities (the ‘eventual recipients’), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met.

(a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.

(b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.

(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in IAS 7 Cash Flow Statements) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.

factor particularly to carry out with its auditors his own methodology while clearly disclosing in the financial statements explanations on the adopted method.

Today, the practice of the market participants are clearly not homogeneous because the complexity of the international accounting standards application leaves the financial statements' preparers with a degree of freedom quite worrying while considering the comparability and understandability principles required by the IASB conceptual framework⁴. It is today particularly difficult to analyze a contract of factoring taking into consideration the various criteria of derecognition as formulated by IAS 39. The elements underlying the standardization debate makes particularly relevant the concerns on the assumptions related to the conditions of a credit assets' transfer. This article has, consequently, vocation to propose methodological guidelines aiming at answering the criteria of derecognition of IAS 39.

The first part of this research will discuss the French civil code-based provisions of the credit assets transfer while the second part will present the IAS 39 features of financial asset derecognition. Finally, a conclusion will come to summarize the contributions of our methodology. It will also discuss some potential improvements and of the future prospects useful for continuity for the work of investigation.

2. French civil code-based provisions of the credit assets transfer

In the case of factoring operations, the IASB principle of “substance over form” seem to potentially oppose the legal view to the accounting interpretation since it states that “it is necessary that they [the transactions] are accounted for and presented in accordance with their substance and economic reality and not merely their legal form” (paragraph 35).

In order to verify this hypothesis, we first examine the law provisions related to a transfer of financial instruments in the French legal environment. International law provisions are then presented to broaden the discussion set.

2.1 Civil code law fundamentals of factoring operations

Under civil code law, principles ruling credit assets transfers call for the definition of factoring operations which greatly rely on the legal principle of conventional subrogation.

2.1.1. Definitions

From a legal point of view, factoring belongs to the class of the “unnamed contracts”, i.e. contracts born from the practice. In a note of information n°21, issued in October 1973, the Banque de France defines the operation of factoring as: “[...] *a transfer of commercial credits of their holder to a factor which is given the responsibility to operate its covering and which guarantees the good end of it, even in the event of temporary or permanent failure of the debtor. Factor can regulate by anticipation whole or part of the amount of the transferred credits*”.

In France, this definition remains, to date, the only text on this subject emanating from a legal authority. Nevertheless other private organizations have proposed, in parallel, their own definitions. As an example, the French Association of Financial Institutions (Association des Sociétés Financières – ASF) contends that the technique of factoring can answer two types of definition depending on the perspective one adopts:

- Strictly speaking, factoring (sometimes called “discount of invoice”) consists in the purchase by a specialized company, of a support representative of a credit. This purchase carries *de facto* the transmission of all the rights, privileges and legal actions attached to this invoice, with the exception of the potential peculiar attached obligations. In other words, a factor, purchaser of the commercial credits that his customer holds towards his own customer-debtors, pays an amount (after deduction of its commissions and fees) of the transfer of property of the aforesaid credits;
- Broadly speaking, factoring can be defined as a technique of financing based on the transfer of invoices or all other personal rights (e.g. drafts accepted and endorsed) at a specialized company, namely a factor.

2.1.2. The conventional subrogation

In practice, factoring is based on a triangular relation, thus utilizing the three protagonists that are the member (i.e. company holder of credits on his own customers, which begin to

⁴ The financial statements issued in 2005 by the factoring companies such as GE FactoFrance, Factorem, BNP

transfer those to the company of factoring); the company of factoring (also called the factor) which is committed to operate the covering of all these credits and regulating, moreover, with the salesman, by way of conventional subrogation, the amount of the credits which it agreed to guarantee; and the purchaser (i.e. the customer of the member) who, once contracted subrogation, knows nothing any more but the factor for the payment of the supplies of the salesman. This tripartite relation implies that the contract of factoring is, first of all, founded on the legal concept of *intuitu personae*, i.e. on the personal quality of the contract holder. This is why, contrary to the other techniques of ownership transfer, the contract of factoring rests on the legal principle of the conventional subrogation, which allows the transfer of the property of the credit of the salesman the company of factoring (art. 1249 and followings and, in particular, art. 1250 of the French civil code).

In practice, this conventional subrogation is formalized in the following way: the invoices are yielded to the factor, on the assumption of an approval of this latter, and reach him accompanied by a subrogative receipt having to comprise, in an explicit way, the assent of member-yielding, so that there is no dispute on the will of this one to transfer the property from the credits and to subrogate the factor in its rights towards the creditors. Consequently, this transfer is known as *erga omnes*, i.e. opposable to any third-party. Thus, conventional subrogation, apart from the internal procedures at the companies of factoring (acceptance of the credits), do not require the respect of a specific formalism. Accordingly, the requirement of the concomitance between subrogation and the payment require an adapted treatment. For technical and legal reasons, it is not possible to treat in the duration a relation of factoring while paying with subrogating credits by means of accounts – cheques or bill of exchanges because it would not be then possible any more to determine the precise date of subrogation. This is why the factors established the technique of financial account open in its books in the name of its customers.

2.2. The international legal provisions

The international accounting standards can be the subject of a satisfactory interpretation only if the conceptual framework is correctly applied. IAS 39 relating to the accounting of the financial instruments respects the principle of “substance over form” in accordance with

Factor, Eirofactor are very convincing.

the conceptual framework. IFRS framework does not suppose that there is inevitably symmetry between the accounting treatment used by the assignor and the assignee.

3. The IASB conceptual framework principles

One of the fundamental qualitative characteristics conferred by the IFRS conceptual framework to a company's financial statements are: (1) the faithful representation and (2) the substance over form principles. This latter states that if information must present a faithful image of the transactions and other events which it aims at presenting, it is necessary that the transactions and the events be recorded and presented in accordance with their substance and their economic reality and not only according to their legal form.

Thus, this principle would tend to recognize any credits discounted even those falling within the framework of a contract of full factoring, i.e. transmitting all the risks to the factor or which would release the group of any exposure to the risks of recovery of the debts.

Indeed, in the particular case where the economic risk inherent to the credits is not supported any more by the member, this latter would profit from non-risky cash flows while the factor would support the risks inherent to the credits. The fulfilment of the principle of economic reality would imply a derecognition of the credits in the financial statements of the member.

3.1. The financial instruments concept under IAS 39 (IAS 39.15 to 23)

The accounting of the credits under international accounting standards is treated by IAS 39. Regarding the derecognition of a financial credit asset, IAS 39 is governed by the principle of pure and perfect transfer. One of the intrinsic qualities of this principle is the concept of transfer of significant risk. Thus, according to IAS 39, an entity can derecognize a financial credit or part of a financial credit if and only if: the rights of the entity on the cash flows generated by the financial credit (or the part of the financial credit) expired; following a transfer of this credit, the entity will not continue to be implied. In addition, IAS 39 lays out that an entity transferred a financial credit:

- if the rights of the entity on the cash flows generated by the financial credit are transferred;
- if while retaining the right to receive cash flows of a financial credit, it assumes an obligation to transfer these flows with one or more recipients by a contract which observes the three following conditions: payment of only received flows; obligation

to carry out the payments without delay significant; impossibility of selling or of putting in guarantee the credit.

In other words, if the financial credit were transferred, the entity must appreciate if it substantially transmitted all the inherent risks and advantages to the financial credit (association of the concepts of transfer of property and transfer of risk). If necessary, it will derecognize the financial credit. In the opposite, the entity must continue to enter it (e.g. case of the credits discounted) in the active of its assessment. However, it is important to note that neither IAS 39, nor IAS 32 directly refer to the contracts of factoring. Their accounting treatment must thus be carried out in the respect of the assumptions introduced by these standards but also in the light of the principles of the conceptual framework, published in July 1989, which aims to establish the concepts underlying a company's financial statements. In a general way, to preserve their properties weakening under IFRS, the traditional operations of factoring will have to evolve/move and release the companies of all the recourse attached to the credits concerned, which is not inevitably the case, today, in practice. A contract of factoring which will not have been made up to be derecognize by including specific provisions, will tend not to be accounted in this way under IFRS. These accounting issues raise the question of the economic interest even of factoring. As the professionals of factoring note it, to leave the credits of the assessment of the company is neither the vocation first of traditional factoring, nor the motivation first of the customer. Thus, to choose an adequate accounting treatment should, first of all, pass by a taken into account of these economic considerations.

3.2. The analysis of a credit assets transfer under IAS 39 (IAS 39.15 to 23)

From a theoretical and conceptual point of view, an entity carries out an effective transfer of a credit if it transfers control from this credit, i.e., the risks and rewards which are directly attached to the use of the credit. From a practical point of view, IAS 39 clarifies this concept of transfer by imposing a successive examination of the transfer:

- Contractual rights to cash flows of the credit,
- Risks and rewards attached to the credit ownership,
- Control of the credit (if applicable).

A quantitative evaluation process of cash flows is thus privileged by this standard.

- **Contractual rights transfer**

Currently the IFRIC must communicate, during the second six-month period 2006, a lighting on this concept. This proposal must in particular evoke the possible compensations between the rights to compensation by the yielded debtor and the conditional transfers.

- **Risk and rewards transfer**

IAS 39.21 contends that an entity transferred the near total of the risks and advantages inherent in the property from a financial credit if the importance of its exposure to the variability of the future cash flows future related to this credit is not significant any more after the transfer compared to that ascribable to this same credit before the transfer. The concept of “significant variability” proposed by IAS 39, is a purely quantitative criterion and could not, for this reason, guarantee a reasoning resting on exclusively qualitative appreciations. A decision tree communicated by IAS 39 is intended to help the companies in the application of these criteria. In synthesis, when the member neither preserved, nor transferred the near total from the risks and advantages, the examination of his control on the transferred credit must be carried out⁵.

3.3. The concept of « continuing involvement » under IAS 39 (IAS 39.30 to 35)

Under IFRS, when the assignor keeps on having an implication (a “continuing involvement”) in a transferred credit, the share relating to this implication is entered in its assets (in complement on behalf of credits possibly preserved by the assignor) and an associated liability is reported (IAS 39.20 and IAS 39.23). This concept of implication is not stated in any French standard (IAS 39.30). Thus, the liability associated in the active preserved is entered. This liability is evaluated so that the net value of the transferred credit and the associated liability is equal (IAS 39.31):

- At the amortized cost of the rights and obligations preserved by the assignor, if the transferred credit is evaluated at the amortized cost;
- At fair value of the rights and obligations preserved by the assignor, if the transferred credit is evaluated at fair value.

⁵ IAS 39.20 (c)

*

In summary, the guide of application of IAS 39 (§ AG 38) proposes a diagram taking again the conditions justifying a transfer of credit.

[INSERT GRAPH 1 ABOUT HERE]

4. Conclusion

Our study illustrates the difficulty of application of the IAS 39 provisions to the treatment of the factoring operations while adopting the perspective from a transaction ruled by civil-code-based provisions. In order to supplement the work of investigation, research to come will be able to adopt a more deductive prospect while being pressed on mathematical tools allowing modelling for cash flows and the transfers of risk related to the credits. After performing empirical tests on this model suggested, the results of this approach could be compared with those of more qualitative study (e.g. Escaffre and Ramond, 2007) and thus could help to write up a report of relevance on these various analysis prospects.

References

- Armstrong, C., Barth, M., Jagolinzer, A. and Riedl, E. (2007).** Market Reaction to the Adoption of IFRS in Europe, *Working Paper*, Harvard Business School, January 2007.
- Ball, R. (2006).** International Financial Reporting Standards (IFRS): Pros and Cons for Investors, *Accounting and Business Research*, International Accounting Policy Forum, pp.5-27.
- Barth, M. and Landsman, W. (1995).** Fundamental Issues Related to Using Fair Value Accounting for Financial Reporting, *Accounting Horizons*, Vol.9(4), pp.97-107.
- Barth, M., Landsman, W. and Lang, M. (2005).** International Accounting Standards and Accounting Quality, *Working Paper*, Stanford University, March 2005.
- Ernst & Young (2006).** *Première application des IFRS, les pratiques des groupes européens*, CPC édition.
- Escaffre, L. and Ramond O. (2007).** *Analyse de l'impact des normes IFRS sur le traitement comptable des cessions de créances : Une étude de cas auprès d'une société d'affacturage*, Working paper, May 2007, Paris-Dauphine University and University of Angers.
- Gray, R. (2003).** Revisiting Fair Value Accounting – Measuring Commercial Banks' Liabilities, *Abacus*, Vol.39(2), pp.250-61.
- Hague, I. (2004).** IAS 39: Underlying Principles, *Accounting in Europe*, Vol.1, pp.21-6.
- Lundholm, R. and Van Winkle, M. (2006).** Motives for Disclosure and Non-Disclosure: a Framework and Review of the Evidence, *Accounting and Business Research*, International Accounting Policy Forum, pp.43-8.
- Walton, P. (2004).** IAS 39: Where Different Accounting Models Collide, *Accounting in Europe*, Vol. 1, pp.5-16.
- Walton, P. (2006).** Fair Value and Executory Contracts: Moving the Boundaries in International Financial Reporting, *Accounting and Business Research*, Vol.36(4), pp.337-43.

IASB and IFRIC publications

International Financial Reporting Standards and International Financial Reporting Interpretations Committees Comments are respectively available on the website of the International Accounting Standards Board (www.iasb.org) and the International Financial Reporting Interpretations Committee (www.ifric.org). Institutional references made in this article include the followings:

- IASB (2007).** IAS 39 *Financial Instruments: Recognition and Measurement*
- IFRIC Update (2006a).** IAS 39 *Financial Instruments: Recognition and Measurement – Derecognition of Groups of Financial Assets*, March 2006, p.3

IFRIC Update (2006b). IAS 39 Financial Instruments: Recognition and Measurement – Aspects of Derecognition in the Context of Securitisation, May 2006, p.5
IFRIC Update (2006c). IAS 39 Financial Instruments: Recognition and Measurement – Derecognition of Financial Assets, November 2006, p.12

Graph 1. Flow Chart: Evaluation of Whether and to What Extent a Financial Asset is Derecognised under IAS 39 (AG.36)

