Auditors up the balance sheet scrutiny

Companies are receiving greater scrutiny from auditors over IFRS balance sheet accounting treatment of new and existing factoring facilities. It is not that the accounting rules have changed, but assessment and enforcement have become more deliberate.

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When employing IFRS off-balance securitisation and factoring structures, companies are governed by IFRS 10 (superseded IAS 27 and SIC-12) and IFRS 9 (superseded IAS 39). These standards require an in-depth series of steps necessary to achieve de-consolidation and de-recognition. The two primary areas of focus of these standards entail analyzing control and variability of risk and rewards associated with the transfer of assets.

The consolidation principles under IFRS 10 must first be applied to determine which party has substantial power and control over the assets once they have been transferred to a special purpose entity ("SPE") or a factor. Companies must present proper legal documentation (i.e. true sale opinions), noting the roles and responsibilities of each party to the transaction to properly substantiate their conclusions to their auditors.

The next step in the off-balance sheet process involves assessing the de-recognition of assets under IFRS 9. Companies must analyze whether the rights to the asset's cash flows as well as the exposure to the risk and rewards of the underlying assets have been transferred. This process can be challenging and must be critically analyzed by examining the transferor's exposure to cash flow variability before and after the transfer. Under IFRS 9, if sufficient transfer of variability of risk and rewards has been evidenced, assets can be de-recognized from the balance sheet.

When securitising assets, Finacity has created a four-tranche funding structure with a second loss tranche sized to capture sufficient variability of risk and reward. When the second loss tranche is conveyed to an independent investor, in conjunction with the transfer of certain control features to a qualified third party, the transaction has proven to comply with the de-consolidation and de-recognition requirements of IFRS 10 and IFRS 9. Finacity's off-balance sheet modeling utilizes Monte Carlo simulations to determine appropriate tranche sizes and assess the transfer of the variability of risk and

reward to help assist clients in implementing and maintaining their desired balance sheet presentation. In addition, Finacity is also equipped to help clients address the control features that are required in this structure.

When factoring assets, proper legal documentation and assessment of the variability of risk and reward is critical in de-recognizing assets. Adequate transfer of variability of risks and rewards can be accomplished via an outright sale of approved receivables associated with specific obligors and/or through the sale of trade credit insured receivables.

Adequacy of the transfer of variability of risk and reward

Credit insurance

For factoring and securitisations, credit insurance policies are often procured for the purpose of transferring sufficient variability of risk and reward, a necessary element to achieving IFRS off-balance sheet treatment. Some policy premiums have a feature involving retroactive repricing based on actual losses and associated claims. While this is certainly a valid commercial component to an insurance policy with the legitimate purpose to motivate an insured to effectively manage its credit risks, such retroactive pricing of the premium owed means that less of the variability of risk and reward is transferred. Finacity has observed that audit firms have increasingly noticed such premium adjustment features, and where applicable, have appropriately questioned the IFRS off-balance sheet treatment. An available solution is for the premium definition to be renegotiated to eliminate any retroactive repricing, but of course this would require an accommodation on the part of the trade credit insurance company and presumably a higher fixed premium payable by the insured.

Finacity has been active with Excess of Loss (XoL) policies since 2006, facilitating a securitisation for Alliance One International (AOI). In recent years there has been an increase in XoL insurance coverage. It should be noted that due to the typically high retained risk in the form of a large deductible, while XoL policies are helpful for financings, they do not facilitate achieving IFRS off-balance sheet treatment.

Delinquency interest

Many factoring agreements include the payment of interest for delinquent receivables. This is a legitimate commercial element to a factoring agreement, intended to motivate better credit performance metrics and compensate the factoring company for delayed payment and credit risk. Interest payments for delinquent receivables reduces the extent to which the variability of risks and rewards are transferred. Finacity has observed that audit firms have increasingly taken note of such commercial terms as having implications for whether or not a company achieves IFRS off-balance treatment. An option to address this issue is to change the terms of the factoring agreement to eliminate payment of interest for delinquent receivables. Of course, this would

understandably need to be acceptable to the factoring company and would presumably cause the associated factoring fees to be increased.

Another option, applicable to both variable insurance premiums and payment of interest for delinquencies, is to develop a Monte Carlo simulation model to capture allocation of the variability of risks and rewards across the constituents. Such an analytic exercise can determine the extent to which structural adjustments are necessary to comply with IFRS 9 and IFRS 10, as applicable. Finacity has developed a multi-tranche securitisation structure with an overlay of Monte Carlo simulations (for optimisation of tranche sizes) to address sufficient transfer of the variability of risks and rewards to achieve off-balance sheet treatment at the lowest all-in-cost. This methodology can be applied to factoring and securitisation structures, with and without credit insurance (and when insured, with and without retroactive premium pricing).

Conclusion

It is no longer sufficient to justify IFRS off-balance sheet treatment simply because a company has entered into a factoring sale agreement and/or a credit insurance policy has been put in place in connection with a receivables factoring or securitisation facility. The details associated with commercial terms (e.g. with respect to potential retroactive insurance premiums and/or interest payable for delinquent receivables) needs to be scrutinized. To achieve IFRS off-balance sheet treatment, support for sufficient transfer of variability of risks and rewards must be analytically evidenced.

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