Some aspects of factoring operations

Introduction

1. The aim of this GFS interpretation is to provide further technical guidance on selected issues related to the recording of factoring operations in ESA financial accounts and balance sheets in application of the Eurostat decision on government deficit and debt of 31 July 2012 on the statistical recording of some operations related to trade credits incurred by government units.[1] The 2012 decision prescribes a reclassification of government liabilities upon factoring without recourse, from being a trade credit (AF.81) granted by a supplier to being a loan (AF.4) granted by a factor. The need for a GFS interpretation on factoring without recourse arose from a recording issue that appeared in ESA table 27 and concerns the treatment of the discount.

2. These issues concern operations where suppliers of goods or services to government use the services of a factor to ensure the management of invoices presented to customers and borrow to anticipate payments before the payment dates agreed with the government unit. Factoring involves an entity (first party, the supplier of goods or services) selling the amounts receivable on its invoices to a customer (second party, which here is government) to a third party (the 'factor', a financial institution classified in S.125 or even in S.122, which may be independent or a subsidiary of a bank). The factor processes the invoices and allows the suppliers to obtain cash earlier than they would otherwise get from the customer. Essentially, factors typically provide financing, debt collection and ledger management services (or some of these).

References in ESA 2010 and rationale for the recording

3. When goods or services are delivered with payment allowed at a later date, a trade credit (AF.81) position is created (ESA 2010 paragraphs 5.124, 5.233 and 5.234). When the maturity of the credits is long-term it is classified as loan (AF.42, ESA 2010 paragraph 20.132), so trade credits granted to government are of a short-term nature. The 2012 Eurostat decision states that:

   "*When a supplier of goods or services, holding a claim on a government unit, which is recorded as a trade credit (AF.81) in national accounts, transfers totally and irrevocably its claim to a financial institution (notably a unit engaged in factoring activity), the original liability of the government unit recorded as trade credit AF.81 has to be reclassified as a loan (AF.4)*."

4. The rationale for the recognition of a change in the nature of the claim is that, by entering into a transaction of factoring with the transferor, the factor establishes an unquestionable claim on government, which is viewed as a loan. The situation is viewed as if the factor is extending finance to the customer/government, which the latter uses to pay the supplier earlier than initially anticipated. For consistency, the reclassification must also apply in the accounts of the counterparty (government). This new claim is no longer considered directly linked to the original commercial transaction and its payment. The maturity classification of the loan (AF.41 or AF.42) will follow the arrangement between factor and government unit in accordance with ESA 2010 paragraphs 5.115 and 5.A1.14.

5. In addition, ESA 2010 paragraph 5.125 states that trade credits are distinguished from loans to finance trade, the latter being classified as loans (AF.4). In the case of factoring, the factor is *de facto* extending lending to finance trade.

6. In a similar vein, ESA 2010 paragraph 20.132 foresees that a long-term trade credit is to be classified in AF.42 because, by offering a long maturity on the financial arrangement, the supplier

[1] http://ec.europa.eu/eurostat/documents/1015035/2041337/Statist-record-of-some-operations-rel-to-trade-credits-i.pdf/f2238d11-9257-4a0e-bd9a-39dcf1fb2cfd

assumes a financial role that is distinguished from its other activity as a producer.

7. The factoring transaction is for government a purely financial transaction implying only a change in financing instrument, from a trade credit (AF.81) to a loan (AF.4), and a change in the counterpart, from the supplier to the factor. The value of the liability remains unchanged in the balance sheet of government, although it is now counterparted by an asset of the same value in the factor's balance sheet.
8. ESA 2010 paragraphs 7.70 and 7.90 state that AF.4 and AF.8 are respectively recorded at nominal value, for both creditors and debtors. Most trade credits do not formally accrue interest, but in case the debtor has recognised interest on the trade credit, the nominal value of the claim includes the amount of interest accrued but not paid. After the transfer of the claim from the supplier to the factor, any interest outstanding on the original trade credit is part of the transfer to the factor.
9. Two recording issues have to be addressed: (i) how to record the change in nature of the claim from trade credit to loan, and (ii) what is the nature of the discount at which the claim is sold off to the factor.

How to record the change in nature of the claim from trade credit to loan

10. ESA 2010 paragraph 6.21 states that a change in classification of assets and liabilities (K.62) occurs where "*assets and liabilities appear under one category in the opening balance sheet and another in the closing balance sheet*" [other than changes resulting from transactions]. ESA 2010 paragraph 6.21 gives a limited set of examples, mainly relating to non-financial assets (changes in land use and dwellings and monetisation / demonetisation of gold bullion), while stating that K.62 does not include the conversion of debt securities into shares, which is instead recorded as two financial transactions. ESA 2010 paragraph 5.150 also refers to the case of listing of stocks, which is recorded as a new issuance of listed shares and as redemption of unlisted shares, delisting being recorded consistently.
11. The restriction of ESA 2010 paragraph 6.21 examples to cases where redemption is not possible and the examples of recording via financial transactions elsewhere implies that changes in instruments are usually to be recorded in the ESA 2010 as financial transactions rather than changes in volume.
12. Hence, the GFS interpretation is that the change in the nature of the claim due to the factoring of a trade credit is to be recorded as the redemption of the trade credit and the granting of a loan by the factor to government. The transaction in cash from the factor to the supplier can either be interpreted as rerouted through government, with a loan in cash and a redemption of trade credit in cash, or as trade credit redemption made on behalf of a third party.
13. Recognising the incurrence of a loan in the financial accounts is also consistent with the fact that the factor, prior to the purchase, ensures that the debtor (here government) effectively ‘accepts’ the liability, such that the asset of the supplier is not only an internal accounting entry in the books of the supplier, created upon sending of the invoice.
14. The loan (AF.4) will have exactly the same value as the trade credit redeemed (AF.81), i.e., the nominal value of the claim.

Nature of the discount at which the claim is exchanged between the seller and the factor

15. When factors economically take over trade credits from suppliers, the price paid will be lower than the nominal value of the trade credit. This discount reflects the fact that the factor takes over the trade credit for commercial reasons. The financial transaction are recorded at their nominal value and the price difference will be recorded as income for the factor from the supplier since the factor needs it to cover its costs (collection, administration, funding), possible losses on debtor defaults, and to make a profit on the operation.
16. The discount should not be classified as an other economic flow, despite this usually being the recording approach when loans or other receivables are sold off at a different value to the

nominal value. ESA 2010 paragraphs 6.58 and 6.63 indeed indicate that, in such cases of sale of loans/other receivables, the difference between the purchase price and the nominal value leads to a revaluation prior the sale in the account of the seller and to a matching revaluation after the sale in the account of the buyer. However, such a recording would have the consequence that the factor would have no income and no output to meet its costs, notably its operating costs. The splitting off of the discount as a non-financial transaction may be seen as an example of partitioning transactions according to ESA 2010 paragraphs 1.76 and 1.77.

17. The interpretation is that the factor’s activity/profession is providing financial services to suppliers and that, as a result, the discount should be seen as income – similarly to indirectly measured income for security traders foreseen in ESA 2010 paragraph 3.73 (which similarly classify differences in prices charged on successive trading as income, rather than holding gains). In addition, ESA 2010 paragraph 6.63’s last sentence may perhaps imply (a bit cryptically) that the discount on short-term trade credit is not a revaluation upon sale, but instead it is income. (“*Nonetheless, as trade credit generally has a short-term nature, the sale of a trade credit might imply the creation of a new financial instrument*.”)

18. This income flow is not interest (D.41) because there is no liability/asset link between the supplier and the factor in the case of accepted factoring, including non-recourse factoring. In addition, the debtor (the general government unit) does not recognise any interest associated with the factoring operation.

19. The GFS interpretation is that the income reflects a purchase of a service i.e., intermediate consumption (P.2) of the transferor and market output (P.11) of the factor.

Conclusions on the recording in government finance statistics

20. As the only recording for government will be financial transactions, factoring operations between factors and suppliers will have no impact on general government B.9/ B.9f.

21. The AF.4 instrument created should have the same value as that of the existing AF.81, i.e., the nominal value of the original claims on the debtor at the time of the factoring without recourse operation.

22. The conversion of the instrument from trade credits to loans is recorded as financial transactions, not as other change in volume due to reclassification of instrument (K.62). The transactions involving government (redemption of trade credit liability (F.81) and issue of loan liability (F.4)) have the same value.

23. No nominal holding gains and losses (K.7) have to be recorded because the difference between the price paid/payable and the nominal value is recorded as a service payment (P.2) by the supplier to the factor.

Illustration/ T-accounts

The following T-accounts illustrate the recording of the factoring operation. Three parties are involved, government (S.13), the supplier (S.11) of goods and services to government and the factor (S.12). The trade credit has no interest rate. The value of the trade credit liability is 100 in the opening balance sheet and this remains the value at the time of the factoring operation. The cash received by the supplier is 90, the remaining 10 being a service charge that fully accrues at time of factoring.

Transactions (t-1) - purchase of good/service by government

S.13				S.11				S.125 = Factor			
Assets/ Uses		Liabilities		Assets		Liabilities/ Resources		Assets		Liabilities	
P.2	100					P.11	100				
B.9/B9f	-100			B.9/B9f	100			B.9/B9f	0		
		F.81	100	F.81	100						

Stocks (t-1)

S.13				S.11 = Supplier				S.125 = Factor			
Assets		Liabilities		Assets		Liabilities		Assets		Liabilities	
		AF.81	100	AF.81	100						

Transactions (t) - factoring

S.13				S.11 = Supplier				S.125 = Factor			
Assets/ Uses		Liabilities/ Resources		Assets/ Uses		Liabilities/ Resources		Assets/ Uses		Liabilities/ Resources	
				P.2	+10					P.11	+10
B.9/B9f	0			B.9/B9f	-10			B.9/B9f	10		
		F.4	+100	F.2	+100			F.2	-100		
					-10				+10		
		F.81	-100	F.81	-100			F.4	+100		

Stocks (t)

S.13				S.11 = Supplier				S.125 = Factor			
Assets		Liabilities		Assets		Liabilities		Assets		Liabilities	
		AF.4	100					AF.4	100		

Transactions (t+1) - redemption of loan

S.13				S.11 = Supplier				S.125 = Factor			
Assets/ Uses		Liabilities/ Resources		Assets/ Uses		Liabilities/ Resources		Assets/ Uses		Liabilities/ Resources	
B.9/B9f	0			B.9/B9f	0			B.9/B9f	0		
F.2	-100							F.2	100		
		F.4	-100					F.4	-100		

Stocks (t+1)

S.13				S.11 = Supplier				S.125 = Factor			
Assets		Liabilities		Assets		Liabilities		Assets		Liabilities	
		AF.4	0					AF.4	0		