

ASSESSING A TRANSACTION INVOLVING AN EXCHANGE OF AN INTEREST IN THE FUTURE CASH FLOWS ASSOCIATED WITH A SPECIFIC EXISTING RECEIVABLE

An exchange of an interest in the future cash flows associated with a specific existing receivable should be recognized for financial reporting purposes as a collateralized borrowing rather than a sale *unless* the appropriate criteria are met.

The most significant factor distinguishing sales from borrowings is the continuing involvement of the transferor. Certain criteria must be met that demonstrate that the transferor is no longer actively involved with the specific existing receivables it has transferred to another party.

A significant aspect of the assessment is the degree to which the transferor retains or relinquishes to the transferee control over the existing receivables. A transaction in which the transferor receives or is entitled to proceeds in exchange for the future cash flows from existing receivables should be reported as a sale if the transferor's continuing involvement with these receivables is effectively terminated.

The determination of whether the transferor's continuing involvement is effectively terminated is dependent upon an evaluation of the following criteria. A "yes" answer to any one of the questions indicates the transferor's continuing involvement is not effectively terminated and, therefore, the transaction should not be reported as a sale.

Questions 1–3 outline the criteria to determine whether the substance of the transaction is indicative of whether the sale has been substantively consummated.

1. Is the transferee's ability to subsequently sell or pledge the receivables significantly limited by the constraints imposed by the transferor, either in the transfer agreement or through other means?
2. Does the transferor have the option or ability to unilaterally substitute for or reacquire specific accounts from among the receivables transferred?

Note: The ability or obligation to substitute for defective accounts, at the option of the transferee would not violate this criterion. For example, accounts that do not possess the characteristics stipulated in a transfer agreement may be replaced by ones that do possess those traits. In addition, insignificant "clean-up" calls by which the transferor may reacquire remaining uncollected accounts when the outstanding impaired balance reaches a specified maximum amount would likewise not violate this criterion.

3. Is the sale agreement cancelable by either party, including cancellation through payment of a lump sum or transfer of other assets or rights?

Questions 4–6 outline the criteria to determine whether the transferee has a separate legal standing from the transferor.

4. Is the transferee's legal entity the same as the transferor's legal entity?
5. Do the corporate powers of the transferee fail to distinguish it as being legally separate from the transferor?
6. Do the corporate powers of the transferee preclude it from being sued in its own name without recourse to the transferor, or preclude it from the right to buy or sell, lease or mortgage property without the transferor's approval?

Question 7 outlines the criteria to determine whether the receivables are isolated from the transferor should it become the subject of a bankruptcy proceeding.

7. Do provisions in the transfer agreement (or provided elsewhere in statutes, charters or other governing documents or agreements) fail to protect the transferee from the claims of the transferor's creditors?

If "yes" to any one of Questions 1–7, the transferor has continuing involvement and the transaction must be recorded as a collateralized borrowing, not a true sale of the receivables.

If “no” to all of Questions 1–7, continue to assess whether the receivables are isolated from the transferor. Generally, banking arrangements should eliminate access by the transferor or its component units to the cash generated by collecting the receivables. Access is eliminated when payments on individual accounts are made directly to a custodial account maintained for the benefit of the transferee.

8. Are payments on individual accounts made through the transferor (and, presumably, then remitted to the transferee), as opposed to payments on individual accounts made directly to a custodial account maintained for the benefit of the transferee?

If the answer to all of Questions 1–7 and Question 8 is “no”, then the transaction must be reported as a true sale of receivables and not a collateralized borrowing.

If the answer to Question 8 is “yes” it tentatively leads to a presumption of a collateralized borrowing that may be mitigated by “no” answers to the following questions. It may be that the transferor continues to service the accounts, or obligors may misdirect their payments to the transferor rather than the transferee. In this circumstance, access to the cash generated by collecting the receivables is deemed to be eliminated if all of the answers to the following questions are “no.”

9. Does the transferor have an obligation to advance amounts to the transferee before it collects equivalent amounts from the underlying individual accounts? Note: The payments to the transferee should be made only from the resources generated by the specific receivables rather than from the transferor’s own resources.
10. Is the cash collected by the transferor on behalf of the transferee remitted to the transferee after significant delay?
11. Are earnings on invested collections held by the transferor instead of passed on to the transferee?
12. Do the transferor’s general ledger and accounts receivable sub-ledger fail to consider sale proceeds from the transferee as satisfaction of individual accounts?
13. Does the transferor fail to indicate in its records which accounts have been transferred and which collections pertain to those accounts?

If the answers to Questions 1–7 and 9–13 are “no,” notwithstanding the fact that the answer to Question 8 is “yes,” then the transaction must be recorded as a true sale, not as a collateralized borrowing.

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