EFRAG Secretariat: Filipe Alves
Ioana Kiss

Supplier Finance Arrangements
Cover Note

Objective

1 The objective of this session is to seek EFRAG TEG's views on the key messages to be considered in the EFRAG Draft Comment Letter on the IASB's project on *Supplier Finance Arrangements*.

2 The key messages are based on the feedback received from discussions on the topic with EFRAG TEG, EFRAG User Panel and EFRAG FIWG.

Agenda papers

3 In addition to this cover note, agenda paper 07-02 *Supplier Finance Arrangements – Key messages for EFRAG DCL* has been provided for the session.

Project background

4 In early 2020, the IFRS Interpretations Committee ('the Committee') received a request about reverse factoring arrangements, more specifically:

(a) how an entity presents liabilities to which reverse factoring arrangements relate (i.e. how it presents liabilities to pay for goods or services received when the related invoices are part of a reverse factoring arrangement); and

(b) what information about reverse factoring arrangements an entity is required to disclose in its financial statements.

5 In a reverse factoring arrangement, a financial institution agrees to pay amounts an entity owes to the entity's suppliers and the entity agrees to pay the financial institution at the same date as, or a date later than, suppliers are paid.

6 Following research and outreach activities, the IASB Staff identified that entities report reverse factoring arrangements in diverse ways, and the extent to which entities provide information about reverse factoring arrangements can vary. Particularly in the statement of financial position (i.e. presentation of trade payables or other financial liabilities) and statement of cash flows (i.e. presentation of operating cash flow or financing cash flow). Finally, the research showed that entities often do not disclose the existence of reverse factoring arrangements.

7 In June 2020, the Committee published an agenda decision which concluded that current principles and requirements in IFRS Standards provide sufficient guidance for entities to apply to reverse factoring arrangements.

8 In December 2020, the IASB supported the agenda decision which highlighted the requirements that already exist in IFRS Standards to meet some of the information needs of investors.

9 However, in June 2021, after discussing the feedback received from investors and analysts, the IASB tentatively decided to add a narrow-scope standard-setting project to address investor information needs related to supplier finance arrangements, in particular to:

(a) explain the type of arrangements within the scope, rather than include specific definitions;

(b) add qualitative and quantitative disclosure requirements to IAS 7;

(c) add 'sign-posts' to existing disclosure requirements in IFRS 7.

10 The IASB's tentative decisions on the project are include in agenda paper 07-02.

EFRAG previous discussions on the project

Feedback from EFRAG TEG

11 EFRAG TEG already discussed this topic when commenting on the IASB's Exposure Draft *General Presentation and Disclosures*.

12 More specifically, in paragraphs 167 to 171 of its comment letter, EFRAG highlighted that:

"Currently, in IFRS Standards, there is no specific reference to reverse factoring, however, there are accounting standards requirements that are relevant in determining the appropriate accounting policies (IFRS 9, IAS 1 Presentation of Financial Statements, IAS 7). Applying these standards requires significant judgement, particularly, as reverse factoring arrangements can differ significantly.

Therefore, EFRAG would welcome specific reference whether this type of liabilities should be presented as trade payables or as a financial debt/borrowing (from bank) in the statement of financial position. Similarly, EFRAG would welcome guidance on whether payments related to reverse factoring is best presented as an operational cash flow or a financing cash flow in the statement of cash flows.

Furthermore, better disclosure requirements are necessary in situations such as reverse factoring where an intermediate is used to pay trade receivables (supply chain financing arrangements).

In those arrangements, the classification of such transactions as trade creditors is included in working capital changes and forms part of the operating cash flows instead of representing a financing liability in the financing cash flows. This reduces the transparency of information by smoothing operating cash flows and understating borrowings.

EFRAG acknowledges that the IFRS Interpretations Committee is currently discussing this topic and any clarifications on this topic would be welcomed."

13 In September 2021, EFRAG TEG discussed this project and provided the following feedback to EFRAG Secretariat:

(a) highlighted the importance of having disclosures on liquidity risks related to the fact that an entity has concentrated part of its liabilities on a single finance provider (rather than a diverse group of suppliers) and that an entity (or its suppliers) has become reliant to the extended payment terms (or earlier payment) provided by the arrangement. Thus, if the arrangement is withdrawn, it could affect the entity's ability to settle liabilities when they are due;

(b) highlighted that gross-up information of reverse factoring arrangements in the statement of cash flows may provide relevant information to users of financial statements (i.e. information about a cash outflow from operating activities and a cash inflow from financing activities when the invoice is factored by the financial institution; and a cash outflow from financing activities when the entity settles the liability). In particular, the IASB should clarify whether gross cash flows may exist if, for example, the financial institution acts as the entity's paying agent in a reverse factoring arrangement (including whether it would be an accounting policy);

(c) considered that it is fundamental to have disclosures on whether an entity has negotiated extended payment terms with its suppliers as a consequence of the supplier finance arrangement being in place;

(d) highlighted the importance of having disclosures about the impact of supplier finance arrangements on leverage, liquidity and working capital cycle;

(e) highlighted the importance of having disclosures on the accounting policies applied by management to such liabilities, including the classification in the statement of financial position, statement of financial performance and statement of cash flows;

(f) noted that it is difficult to define what a supplier finance arrangement is. Therefore, this would be an area to focus on when the ED is published;

(g) some considered that the liabilities that arise from supplier finance arrangements should always be presented separately, if material;

(h) highlighted the importance of clarifying the presentation of income and expenses that arise from supplier finance arrangements when the entity settles invoices that are part of the arrangement on the due date as negotiated with its suppliers but suppliers can choose to be paid earlier than the invoice due date by the finance provider, at a discount;

(i) acknowledged the difficulties of splitting how much of the liability represents a loan payable and how much of the liability represents a trade payable.

Feedback from EFRAG User Panel

14 In November 2019, the EFRAG User Panel members discussed *Disclosures on the Sources and Uses of Cash*, the output from the FRC Financial Reporting Lab project, presented by Philip Fitz-Gerald, on how companies can give more information and context around cash disclosures, particularly for reverse factoring arrangements (here). In this meeting, EFRAG User Panel members:

(a) welcomed the FRC Financial Reporting Lab project and considered that the accounting issues related to reverse factoring were fundamental;

(b) considered that a reverse factoring transaction should typically result in the presentation of a financial debt in the statement of financial position, particularly when considering that such transactions involve a financial institution, with disclosures to accurately describe the terms of the contract and the maturity of the debt;

(c) nonetheless, some acknowledged that part of the arrangement could be considered as part of working capital (trade receivables), although distinguishing financial debt and working capital would be challenging; and

(d) called for the IASB to open a project and address the accounting challenges related to reverse factoring as soon as possible as this issue was becoming prevalent in many jurisdictions.

15 In November 2020, EFRAG User Panel members discussed the Committee tentative agenda decision on *Supply Chain Financing Arrangements - Reverse Factoring.* EFRAG User Panel members provided the following feedback:

(a) welcomed that the Committee was carefully analysing this issue and welcomed any guidance in this area. These types of transactions were growing exponentially and being used by entities with higher credit risk. Thus, retaining the status quo was not acceptable;

(b) some noted that the Committee seemed to be binary on their analysis. Either reverse factoring was considered an operating transaction or it was a financing transaction. This approach seemed to be too simple as these transactions seemed to have both an operating and financing component, which should be split. Without a split between operating and financing, investors would get misleading information about the levels of working capital and financial debt. Alternatively, if the transaction was entirely presented as trade payables or financial debt, then additional disclosures would be necessary;

(c) some considered that it would be easier to identify any financial liabilities to financial institutions as financial debt;

(d) agreed that having additional disclosures on this topic was fundamental as currently there was lack of information in the financial statements;

(e) in addition to the presentation within the statement of financial position, the presentation within the statement of cash flow needs to be clarified. Operating cash flow might not be comparable between entities and without disclosures about such transactions it could even be misleading; and

(f) considered that the presentation of reverse factoring in the primary financial statements could be addressed within the IASB's project Primary Financial Statements, in particular, to better discuss the substance of such transactions. For example, the terms and conditions of the contracts with suppliers (prices and payment terms) could change due to the use of reverse factoring. Such changes should be considered when analysing the substance of a reverse factoring agreement.

Feedback from EFRAG FIWG

16 In November 2021, the EFRAG FIWG considered the IASB proposals on the project and made the following comments on:

(a) scope – the EFRAG FIWG members acknowledged that the scope of the project was limited to supplier finance arrangements, however, it was noted that there was an increasing number of arrangements related to financing of inventory which should closely monitor by the IASB;

(b) definition for SFA: it was important to properly define SFA as many similar arrangements could be found in practice; it was also important to test the scope of the project (e.g., outreach activities) to better understand whether all the relevant supplier finance arrangements would be in the scope of the project;

(c) proposed disclosures – it was important that entities provide better information about what trade payables would be paid under these arrangements and when (i.e. provide information similar to the maturity analysis for financial debt). Members agreed that the direction of the IASB's proposed disclosures was the right one;

(d) presentation in the statement of financial position - the EFRAG FIWG members agreed that having a clearer boundary between trade payables and financial debt was important, however, developing such a dividing line was highly judgemental and might not be useful when the characteristics of the financial instruments changed regularly. The following observations were made:

 (i) entities sometimes presented a separate category within trade payables for liabilities under a supplier finance arrangement. The separate line item appeared when there was a change to the characteristics of the trade payable but this change was not sufficient to justify reclassification to financial liability;

(ii) the diversity in presentation of liabilities under supplier finance arrangements as trade payables or as financial debt was also a result of different legal frameworks that exist in various jurisdictions. For example, some jurisdictions do not allow the reclassification from operating to financing category;

(e) presentation in the statement of cash flows – the linkage between the statement of financial position and the cash flow statement was important and should be preserved. In their view, a gross presentation in the statement of cash flows could provide useful information about operating cash flows but should only be used in very limited cases. That is, gross presentation would only be acceptable under the supplier finance arrangements (i.e. principle-agent case).

(f) implementation - the implementation period for the project should not be extended as current practices would continue to be applied. Following the publication of the IFRS IC's agenda decision in December 2020, entities had sufficient time to adjust their reporting for supplier finance arrangements, however, no significant changes were observed.

Initial feedback from PIR of IFRS 9

17 Furthermore, the initial feedback from the Post-implementation Review of IFRS 9 *Financial Instruments* has identified a number of issues also related to the classification and measurement of liabilities under supplier finance arrangements. In particular, there was a need for additional guidance on:

(a) the principle-agent area – the PIR of IFRS 9 showed that the issues around reporting for supplier finance arrangements might benefit from adding a clarification in IFRS 9, in particular, whether:

(i) the arrangement was set up by the bank, the buyer or the supplier;

(ii) the payment conditions to the supplier were determined in negotiations between the bank and the supplier or between with the buyer and the supplier; and

(iii) the use of cash discounts was decided by the bank or the buyer;

(b) derecognition requirements in IFRS 9 for liabilities when becoming part of a supplier finance arrangement – it would be useful to specify under which circumstances should the original trade payable be derecognised and if so, when. Further guidance on how the requirements for substantial modifications in IFRS 9 (paragraph 3.3.2 of IFRS 9) should be applied when the buyer performs and assessment on whether the original financial liability has been substantially modified.

EFRAG Secretariat project planning

18 The IASB will issue an exposure draft on the project late in November 2021 and the publication will have a comment period of 120 days. The EFRAG Secretariat is planning to discuss with EFRAG TEG the EFRAG's Draft Comment Letter on the topic in December 2021.

Supplier

- Provides goods and services to the reporting entity
- Can receive payments from a bank ahead of standard timescales, at a discounted rate (e.g. 45 days)

Reporting Entity

- Receives goods and services from supplier
- Reimburses the bank only when the standard payment terms expire (e.g. 120 days)
- May lead to longer payment terms with suppliers, fictitiously improving working capital management
- Main accounting issues:
  - Diversity in practice
  - Lack of disclosures,
  - Presenting related liabilities as operating liabilities in the statement of financial position (e.g. trade payables) and statement of cash flows ('operating activities')
  - Concealing the true level of borrowing to financial creditors