Supplier Finance Arrangements
Cover Note

Objective

1 The objective of the session is to provide EFRAG TEG members an update on the IASB's project *Supplier Finance Arrangements*.

Agenda papers

2 In addition to this cover note, agenda paper 03-02 *Supplier Finance Arrangements - Update* has been provided for the session.

What is the issue?

3 In most common reverse factoring arrangements, a financial institution agrees to pay amounts an entity owes to its suppliers and the entity agrees to pay the financial institution at a date later than suppliers are paid (i.e. arrangements which enable a supplier to receive payment earlier).

4 Currently, in IFRS, 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 *Financial Instruments*, IAS 1 *Presentation of Financial Statements*, IAS 7 *Statement of Cash Flows*). Applying these standards requires significant judgement, particularly, as reverse factoring arrangements can differ significantly.

5 The lack of guidance has created many issues, including:

(a) **Diversity in practice**: 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).

(b) **The financial information presented may not be relevant and not faithfully represent the transaction**: when entities classify the obligations of such contracts as trade creditors, then the obligations are reflected in working capital changes and form part of the operating cash flows instead of representing a financing liability in the financing cash flows. Such accounting treatment can reduce the transparency of information by smoothing operating cash flows and understating borrowings/debt.

(c) **Lack of disclosures:** entities may not disclose the existence of reverse factoring arrangements. When disclosed, their labelling can vary.

6 In addition, a number of questions arise when reporting reverse factoring transactions:

(a) whether the related liabilities should be presented as trade payables or as a financial debt/borrowing (from bank) in the statement of financial position;

(b) 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;

(c) whether gross presentation of reverse factoring arrangements in the statement of cash flows provides relevant information to users of financial statements; and

(d) whether better disclosures requirements are necessary in situations where an intermediate is used to pay trade receivables (supplier finance arrangements).

7 In September 2019 the Financial Reporting Lab of the FRC issued a report on Disclosures on the sources and uses of cash, which also addressed reverse factoring in **Appendix 1 Reverse Factoring** of its report.

8 The analysis showed that good reporting in this area is rare. To drive improvements, the Financial Reporting Lab of the FRC provided practical guidance around the presentation and disclosure of these transactions in their report.

The IFRS Interpretations Committee discussions

9 Early in 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.

10 In April 2020, the IASB Staff conducted research and outreach activities. In summary, the outreach showed that supply chain financing arrangements are sometimes broadly referred to, and identified as, (i) reverse factoring, (ii) dynamic discounting and (iii) supplier inventory financing.

11 The IASB Staff focused its research on reverse factoring arrangements, the most common type of supply chain financing arrangement, and identified two broad types of reverse factoring arrangements:

(a) arrangements enabling a supplier to receive payment earlier (most common); and

(b) arrangements enabling an entity to settle payments later.

12 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 IASB research showed that entities often do not disclose the existence of reverse factoring arrangements.

13 In June 2020 meeting, the IASB Staff provided the Committee with a summary of the matter, their analysis and asked the Committee whether they agreed with the IASB Staff recommendation:

(a) recommend publishing a tentative agenda decision that outlines how IFRS Standards apply to the accounting for reverse factoring arrangements;

(b) to consider a narrow-scope standard-setting project to develop disclosure requirements for arrangements entered into to fund payables to suppliers (i.e. reverse factoring arrangements), including an overall disclosure objective, specific disclosure objectives and disclosure requirements required to meet each specific disclosure objective; and

(c) not to add to its standard-setting agenda the classification of liabilities that are part of reverse factoring arrangements and disclosures about liquidity risks arising from such arrangements.

14 The Committee decided not to add a standard-setting project to the work plan in response to a submission about the existing presentation and disclosure requirements that apply to reverse factoring arrangements. The Committee instead decided to publish an agenda decision that would include material explaining how the applicable principles and requirements in IFRS Standards apply to reverse factoring arrangements.

15 In addition, Committee members also discussed possible narrow-scope standard-setting in relation to supply chain financing arrangements. In particular, whether additional disclosure requirements should be considered to meet investor information needs in relation to those arrangements

The IASB Board discussions

16 On 14 December 2020, the IASB discussed whether any IASB Board members objected to the Committee's decision to publish the agenda decision *Supply Chain Financing Arrangements—Reverse Factoring*. No IASB Board member objected to the agenda decision and the agenda decision was published in the IFRIC Update, which highlights the requirements that already exist in IFRS Standards that meet some of the information needs of investors, including:

(a) when an entity presents a financial liability as a trade payable;

(b) when an entity presents liabilities that are part of a reverse factoring separately

(c) whether and when to derecognise a liability that is (or becomes) part of a reverse factoring arrangement;

(d) whether the related cash flows arise from operating or financing activities;

(e) information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed;

(f) Judgement involved on how to present liabilities and cash flows related to reverse factoring arrangements

17 In June 2021 the IASB discussed whether it should undertake a narrow-scope standard-setting to address project to address investor information needs related to supplier finance arrangements'.

18 After discussing the feedback received from investors and analysts, the Committee and other stakeholders about investor information needs related to supplier finance arrangements, the IASB tentatively decided to add a narrow-scope standard-setting project to its work plan to meet these investor information needs. This project would (more details in agenda paper 03.02):

(a) Explain the type of arrangements within its 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.

19 Finally, the IASB and the Financial Accounting Standards Board (FASB) met on 23 July 2021 for an educational session to discuss this project. The IASB's presentation can be found here.

20 It is worth noting that in 2020 the FASB launched the project *Disclosure of Supplier Finance Programs Involving Trade Payables* to develop disclosure requirements related to supplier finance programs involving trade payables. The FASB conducted some research and concluded that most users asked for disclosure of quantitative and qualitative information including:

(a) Program terms;

(b) Description of financial statement presentation;

(c) Risks of the program;

(d) A rollforward of the amount paid early to suppliers;

(e) Payment terms for participating suppliers; and

(f) Maximum size of the program

Background on the EFRAG TEG discussions

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

22 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."

Background on EFRAG User Panel discussions

23 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.

24 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.

EFRAG Secretariat project planning

25 The IASB is planning to issue an exposure draft in October 2021. Therefore, the EFRAG secretariat is planning to bring this topic again in October 2021 to discuss EFRAG 's Draft Comment Letter.

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