

IFRS Interpretations Committee
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4DG

Submitted electronically

30 September 2020

Dear Committee Members

Tentative Agenda Decision: Supply Chain Financing Arrangements—Reverse Factoring

I am writing on behalf of the UK Financial Reporting Council (FRC) to provide comments on the IFRS Interpretations Committee's Tentative Agenda Decision *Supply Chain Financing Arrangements—Reverse Factoring*, issued in June 2020¹.

We thank the Committee for its contribution to this important topic and the publication of the tentative agenda decision. After the collapse of a significant UK construction business in 2018, the reporting of supply chain financing arrangements has received much attention in the UK, and we are very clear that addressing any reporting weaknesses in this area is in the public interest.

Our research suggests that reverse factoring is a significant funding alternative for certain industry sectors. Nevertheless, we find a gap between the apparent prevalence of these transactions and the information disclosed in financial statements.

In September 2019 the Financial Reporting Lab of the FRC issued a report on *Disclosures on the sources and uses of cash*,² which also addressed reverse factoring. Our analysis showed that good reporting in this area is rare. To drive improvements, we provided practical guidance around the presentation and disclosure of these transactions in our report, which overlaps with the tentative conclusions reached by the Committee. We are, therefore, largely supportive of the content of the tentative agenda decision. Nevertheless, we have doubts whether guidance on existing requirements alone, will be sufficient to improve the quality of reporting.

The Committee discussed the merits of a possible narrow-scope standard setting project. We support a disclosure project to develop clear and specific disclosure requirements that focus the attention of preparers and auditors, provide additional information to users and facilitate effective enforcement. We urge the Committee to make this recommendation to the Board and would support the Committee and the Board in developing the proposals.

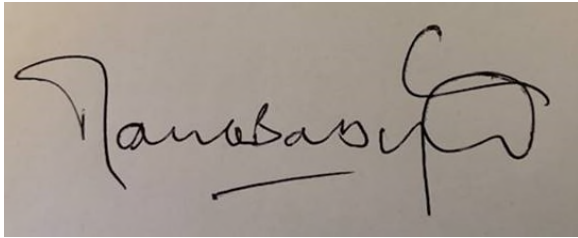
¹ The views expressed by the FRC in this letter are separate from and will not necessarily affect the conclusions of any UK endorsement assessment of any new or amended International Accounting Standard.

² <https://www.frc.org.uk/getattachment/0689ba0c-2a23-4850-b0b9-8bec52938cce/Disclosures-on-the-sources-and-uses-of-cash-Final.pdf>

Our detailed response to the tentative agenda decision is included in the Appendix to this letter.

If you would like to discuss these comments, please contact me or Susanne Pust Shah (s.pustshah@frc.org.uk).

Yours sincerely,

A handwritten signature in black ink on a light-colored background. The signature is written in a cursive style and appears to read 'Mark Babington'.

Mark Babington

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Appendix:

Presentation in the statement of financial position

IAS 1 *Presentation of Financial Statements* specifies requirements for the presentation of liabilities in an entity's statement of financial position. Paragraph 54 requires an entity to present 'trade and other payables' separately from other financial liabilities. 'Trade and other payables' are sufficiently different in nature or function from other financial liabilities to warrant separate presentation (paragraph 57 of IAS 1).

Paragraph 11(a) of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that 'trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier'. Paragraph 70 of IAS 1 explains that 'some current liabilities, such as trade payables... are part of the working capital used in the entity's normal operating cycle'. The Committee therefore concluded that an entity presents a financial liability as a trade payable only when it:

- a. represents a liability to pay for goods or services;
- b. is invoiced or formally agreed with the supplier; and
- c. is part of the working capital used in the entity's normal operating cycle.

Paragraph 29 of IAS 1 requires an entity to 'present separately items of a dissimilar nature or function unless they are immaterial'. Paragraph 57 specifies that line items are included in the statement of financial position when the size, nature or function of an item (or aggregation of similar items) is such that separate presentation is relevant to an understanding of the entity's financial position. Accordingly, the Committee concluded that, applying IAS 1, an entity presents:

- a. other payables together with trade payables only when those other payables have a similar nature and function to trade payables—for example, when other payables are part of the working capital used in the entity's normal operating cycle.
- b. liabilities that are part of a reverse factoring arrangement separately when the size, nature or function of those liabilities makes separate presentation relevant to an understanding of the entity's financial position. In assessing whether to present such liabilities separately (including whether to disaggregate trade and other payables), an entity considers the amounts, nature and timing of those liabilities (paragraphs 55 and 58 of IAS 1).

The Committee observed that an entity assessing whether to present liabilities that are part of a reverse factoring arrangement separately might consider factors including, for example:

- a. whether additional security is provided as part of the arrangement that would not be provided without the arrangement.

b. whether the terms of liabilities that are part of the arrangement are substantially different from the terms of the entity's trade payables that are not part of the arrangement.

A1 We concur with the Committee's analysis and descriptions of the existing requirements in IFRS. In addition, our outreach has shown that users need clarity on where amounts subject to supplier funding arrangements have been included and the respective balances, but such disclosure is often lacking because not specifically required.

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| Derecognition of a financial liability |
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| An entity assesses whether and when to derecognise a liability that is (or becomes) part of a reverse factoring arrangement applying the derecognition requirements in IFRS 9 <i>Financial Instruments</i> . |
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| An entity that derecognises a trade payable to a supplier and recognises a new financial liability to a financial institution applies IAS 1 in determining how to present that new liability in its statement of financial position (see 'Presentation in the statement of financial position'). |
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A2 We concur that, although a complex area, IFRS provides adequate accounting requirements on derecognition for reverse factoring transactions.

Presentation in the statement of cash flows

Paragraph 6 of IAS 7 *Statement of Cash Flows* defines:

- a. operating activities as ‘the principal revenue-producing activities of the entity and other activities that are not investing or financing activities’; and
- b. financing activities as ‘activities that result in changes in the size and composition of the contributed equity and borrowings of the entity’.

An entity that has entered into a reverse factoring arrangement determines whether to classify cash flows under the arrangement as cash flows from operating activities or cash flows from financing activities. The Committee observed that an entity’s assessment of the nature of the liabilities that are part of the arrangement may help in determining the nature of the related cash flows as arising from operating or financing activities. For example, if the entity considers the related liability to be a trade or other payable that is part of the working capital used in the entity’s principal revenue-producing activities, the entity presents cash outflows to settle the liability as arising from operating activities in its statement of cash flows. In contrast, if the entity considers that the related liability is not a trade or other payable because the liability represents borrowings of the entity, the entity presents cash outflows to settle the liability as arising from financing activities in its statement of cash flows.

Investing and financing transactions that do not require the use of cash or cash equivalents are excluded from an entity’s statement of cash flows (paragraph 43 of IAS 7). Consequently, if a cash inflow and cash outflow occur for an entity when an invoice is factored as part of a reverse factoring arrangement, the entity presents those cash flows in its statement of cash flows. If no cash flows are involved in a financing transaction of an entity, the entity discloses the transaction elsewhere in the financial statements in a way that provides all the relevant information about the financing activity (paragraph 43 of IAS 7).

- A3 We concur with the Committee’s analysis of the requirements for the presentation of reverse factoring arrangements in the cash flow statement.
- A4 A clear analysis of cash generation and spending in an entity is vital for users, especially when the economy is under strain and liquidity risk is increased. To assess the quality of disclosures of cash flows and liquidity risks, in December 2019 the FRC announced a new Thematic Review – *Cash flows and liquidity disclosures*³. As part of this project we will review disclosures of supplier financing arrangements, when they are material. This work will inform us of progress made in terms of quality of disclosure of the impact of reverse factoring arrangements on cash flows and liquidity risk.
- A5 We acknowledge that some prefer a grossed-up presentation of reverse factoring arrangements and hence would include cash flows in operating activities, even if they are notional amounts, ie amounts economically similar to inflows and outflows of cash, rather than actual cash in or outflows of the entity. However, a cash flow statement is a statement of cash in and outflows of the entity and the inclusion of notional amounts, even if that may seem useful, could obscure the “real” cash flows and thereby have a detrimental effect on the relevance of information.
- A6 We prefer that non-cash transactions are transparently reported in the financial statements, for example through a reconciliation between cash flows and profit from

³ <https://www.frc.org.uk/getattachment/1336c2d2-718e-48f7-9eea-644d208e174f/CRR-Press-notice-CF-thematic.pdf>

operating activities. IAS 7 limits the requirement to present non-cash transactions to investing and financing activities, although, as demonstrated for reverse factoring, they could also affect operating activities. We would therefore support extending the disclosure requirement in IAS 7 paragraph 43 to operating activities.⁴

- A7 We also wanted to highlight where we believe the drafting of the agenda decision could be clarified. It currently reads:

Investing and financing transactions that do not require the use of cash or cash equivalents are excluded from an entity's statement of cash flows (paragraph 43 of IAS 7). Consequently, if a cash inflow and cash outflow occur for an entity when an invoice is factored as part of a reverse factoring arrangement, the entity presents those cash flows in its statement of cash flows. If no cash flows are involved in a financing transaction of an entity, the entity discloses the transaction elsewhere in the financial statements in a way that provides all the relevant information about the financing activity (paragraph 43 of IAS 7).

- A8 The sentence starting "Consequently, if ..." is confusing as it may be read to imply that a cash in or outflow might arise at the time an invoice is factored, when in practice we would not expect a cash in or outflow for the recipient of the services. We suggest that this sentence is deleted or the Committee clarifies in what instances it would expect cash in or outflows.

⁴ In the FRC Discussion Paper *Improving the Statement of Cash Flows* published in 2016, we outlined some of the issues and possible solutions to the presentation of reverse factoring arrangements in the cash flow statement. <https://www.frc.org.uk/getattachment/99748001-ddfb-4789-918b-569552416070/-:aspx>

Notes to the financial statements

Paragraph 44A of IAS 7 requires an entity to provide 'disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes'. The Committee noted that such disclosure is required for liabilities that are part of a reverse factoring arrangement if the cash flows for those liabilities were, or future cash flows will be, classified as cash flows from financing activities.

IFRS 7 *Financial Instruments: Disclosures* defines liquidity risk as 'the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset'. The Committee observed that reverse factoring arrangements often give rise to liquidity risk because:

- a. the entity has concentrated a portion of its liabilities with one financial institution rather than a diverse group of suppliers. The entity may also obtain other sources of funding from the financial institution providing the reverse factoring arrangement. If the entity were to encounter any difficulty in meeting its obligations, such a concentration would increase the risk that the entity may have to pay a significant amount, at one time, to one counterparty.
- b. some suppliers may have become accustomed to, or reliant on, earlier payment of their trade receivables under the reverse factoring arrangement. If the financial institution were to withdraw the reverse factoring arrangement, those suppliers could demand shorter credit terms. Shorter credit terms could affect the entity's ability to settle liabilities, particularly if the entity were already in financial distress.

Paragraphs 33-35 of IFRS 7 require an entity to disclose how exposures to risk arising from financial instruments including liquidity risk arise, the entity's objectives, policies and processes for managing the risk, summary quantitative data about the entity's exposure to liquidity risk at the end of the reporting period (including further information if this data is unrepresentative of the entity's exposure to liquidity risk during the period), and concentrations of risk. Paragraphs 39 and B11F of IFRS 7 specify further requirements and factors an entity might consider in providing liquidity risk disclosures.

An entity applies judgement in determining whether to provide additional disclosures in the notes about the effect of reverse factoring arrangements on its financial position, financial performance and cash flows. The Committee observed that:

- a. assessing how to present liabilities and cash flows related to reverse factoring arrangements may involve judgement. An entity discloses judgements that management has made in this respect if they are among the judgements made that have the most significant effect on the amounts recognised in the financial statements (paragraph 122 of IAS 1).
- b. reverse factoring arrangements may have a material effect on an entity's financial statements. An entity provides information about reverse factoring arrangements in its financial statements to the extent that such information is relevant to an understanding of any of those financial statements (paragraph 112 of IAS 1).

The Committee noted that making materiality judgements involves both quantitative and qualitative considerations.

- A9 We concur with the Committee's observations regarding the required disclosures in the notes. However, we have doubts whether this list, although helpful, will drive the improvements we are seeking. We therefore support a narrow scope disclosure standard setting project.
- A10 As noted in Staff Paper 2 of the Committee's meeting in June 2020, users of financial statements look for additional information when reverse factoring arrangements are material, but they are missing because they are not explicitly required. We support disclosures around the items listed in paragraph 57 (a) to (d) of that paper, which include:
- (a) the total amounts subject to reverse factoring arrangements;
 - (b) where, and how, an entity has classified associated amounts in the statements of financial position and cash flows;
 - (c) the nature of reverse factoring arrangements, including any credit term extensions, the effect of the arrangement on the entity's days payable ratio and the duration of that effect (for example, to understand whether improvements in the ratio is one-off or expected to occur in future periods); and
 - (d) the risks to which the entity is exposed, for example liquidity risks from reverse factoring arrangements and how the entity manages those risks.