Staff paper

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Project	**Supplier Finance Arrangements**
Topic	**Feedback Analysis—Project approach**
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Introduction

Purpose of the paper

1. As discussed in Agenda Paper 12B for this meeting, this paper sets out our analysis and recommendations having considered comments received on the approach taken in the Exposure Draft *Supplier Finance Arrangements* to address information needs of users of financial statements (investors) by adding disclosure requirements about an entity's supplier finance arrangements (SFAs).

Structure of the paper

2. In this paper, we discuss the disclosure-only approach in the project, including:
   (a) the need to add to existing disclosure requirements about an entity's SFAs; and
   (b) alternative approaches to address investor information needs.
3. We include in each section:
   (a) IASB's proposals and rationale;
   (b) respondents' feedback[1]; and
   (c) staff analysis and recommendations.
4. Our staff recommendations are summarised in paragraph 6 and the question for the IASB is after paragraph 20.
5. The appendix to this paper includes the December 2020 Agenda Decision *Supply Chain Financing Arrangements—Reverse Factoring*.

[1] Agenda Paper 12A and Agenda Paper 12E for the International Accounting Standards Board (IASB)'s July 2022 meeting summarised respondents' feedback on the project approach.

Summary of staff recommendations

6. We recommend that the IASB:

    (a) proceed with adding disclosure requirements about SFAs to IFRS Accounting Standards; and

    (b) make no change to the approach to this narrow scope, disclosure-only, project.

The need for disclosure requirements

IASB's proposals and rationale

7. As the Agenda Decision (set out in the Appendix) explains, IFRS Accounting Standards already include requirements that meet some of the information needs of investors with respect to reverse factoring arrangements. The IASB proposed adding disclosure requirements about SFAs in a way that complements the requirements in IFRS Accounting Standards. The proposals aim to balance implementation costs for entities and others with the benefits of the information for investors.

8. Paragraph BC4 of the Basis for Conclusions on the Exposure Draft explains that the IASB was informed that, without amendments to the current disclosure requirements, investors may be unable to obtain from financial statements some of the information they need to understand an entity's SFAs and may, therefore, be hindered in comparing one entity with another. In the absence of standard-setting, the IASB expects the information entities provide about SFAs to continue to vary in detail and quality.

Respondents' feedback

9. Most respondents said there is a need to improve disclosure about an entity's SFAs. A few respondents disagreed with the need for, or expressed concerns about, the project. Some of these respondents said the current disclosure requirements are sufficient and adding new specific disclosure requirements each time there is a 'gap' in the requirements may not be the most efficient way to proceed.

Staff analysis and recommendations

10. Respondents' feedback largely affirmed the IASB's reasons for proposing amendments to IAS 7 *Statement of Cash Flows* and IFRS 7 *Financial Instruments: Disclosures*. As we discuss in Agenda Papers 12D–12F, feedback from investors in particular confirmed that (a) there is a need for additional disclosure of information about an entity's SFAs; and (b) improvements can be achieved through the IASB's proposed targeted amendments to IFRS Accounting Standards. We are persuaded by investor feedback and our research that the current disclosure requirements fail to meet some of the information needs of investors related to SFAs, and entities do not voluntarily meet those investor information needs.

11. Respondents' feedback broadly affirmed our understanding that:

(a) investors require information about SFAs that is comparable both from period to period for a reporting entity and in a single reporting period across entities;

(b) SFAs can be a useful tool that allows entities and their suppliers to improve their working capital management—however, this benefit can disappear quickly if, in a stress scenario, the finance providers withdraw the arrangement; and

(c) because of the potential risks associated with SFAs, investors want to know about the existence of SFAs and assess the extent to which the entity's working capital and liquidity are tied to the entity's use of these arrangements.

12. Paragraph 7.4 of the *Conceptual Framework for Financial Reporting* says when 'developing presentation and disclosure requirements in IFRS Accounting Standards a balance is needed between:

(a) giving entities the flexibility to provide relevant information that faithfully represents the entity's assets, liabilities, equity, income and expenses; and

(b) requiring information that is comparable, both from period to period for a reporting entity and in a single reporting period across entities.'

13. In our view, the proposals largely achieve this balance. The IASB proposed to add a minimum amount of new requirements to complement current disclosure requirements in a way that allows entities the flexibility to provide relevant entity-specific information.

14. We therefore recommend that the IASB proceed with adding disclosure requirements about SFAs to IFRS Accounting Standards. We discuss in Agenda Papers 12D–12F our recommendations on specific aspects of the disclosure proposals.

Alternative approaches

IASB's proposals and rationale

15. Paragraph BC20 of the Basis for Conclusions on the Exposure Draft explains that the IASB considered whether to add requirements to IAS 1 *Presentation of Financial Statements* to help assess whether the nature of financial liabilities within the scope of the proposed requirements is similar to, or dissimilar from, that of trade payables or other financial liabilities. The IASB also considered adding requirements to IAS 7 to clarify how to identify when a cash flow has occurred (for example, to help assess when a finance provider acts as a paying agent on an entity's behalf). The IASB decided not to address classification and presentation in the statements of financial position and cash flows as part of this project—such a project would need to consider a wider range of liabilities and cash flows than only those related to SFAs.

Respondents' feedback

16. Many respondents suggested that the IASB either expand the scope of the current project or pursue a future project to address classification and presentation of liabilities and cash flows associated with SFAs. These respondents said additional work is needed on classification and presentation to enhance transparency and consistency in application.

17. Respondents suggested that the IASB could, for example:

    (a) address when an entity classifies a financial liability as a 'borrowing' and no longer as a trade payable;

    (b) add requirements to IFRS 9 *Financial Instruments* about when an entity derecognises a trade payable that is part of an SFA and recognises a liability to a finance provider; or

    (c) undertake a broader review of IAS 7 to make it fit for purpose in the current economic environment and improve disclosures on non-cash transactions.

18. A few respondents suggested that, instead of proceeding with the proposals, the IASB consider whether there is evidence of the need for standard-setting dealing with working capital arrangements more broadly.

Staff analysis and recommendations

19. In our view, respondents' feedback did not provide persuasive new information to support a change in approach on this project. Standard-setting that deals with broad topics, such as presentation and classification in the statements of financial position and cash flows, are best addressed separately or as part of other IASB projects. Relevant developments in other projects include that the IASB:

    (a) published in July 2022 the Feedback Statement on its *Third Agenda Consultation*. The IASB added to its research pipeline a project on the statement of cash flows and related matters;

    (b) added in July 2022 to its pipeline projects a project to review matters about amortised cost measurement that were identified through the *Post-Implementation Review of IFRS 9—Classification and Measurement*. This project will consider, among other matters, modifications of financial assets and liabilities; and

    (c) is redeliberating proposals in the Exposure Draft *General Presentation and Disclosures*. The Primary Financial Statements project proposes to improve how information is communicated in the financial statements, with a focus on the statement of profit or loss.

20. Considering respondents' feedback and these other project developments, we recommend that the IASB make no change to the approach to this narrow scope, disclosure-only, project.

Question for the IASB

Does the IASB agree with our recommendations set out in paragraph 6 to: (a) proceed with adding disclosure requirements about SFAs to IFRS Accounting Standards; and (b) make no change to the approach to this narrow scope, disclosure-only, project.

Appendix—Agenda Decision *Supply Chain Financing Arrangements—Reverse Factoring*

Supply Chain Financing Arrangements—Reverse Factoring

The Committee received a request about reverse factoring arrangements. Specifically, the request asked:

a. how an entity 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.

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.

Presentation in the statement of financial position

IAS 1 *Presentation of Financial Statements* specifies how an entity is required to present its liabilities in the statement of financial position.

Paragraph 54 of IAS 1 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 55 of IAS 1 requires an entity to present additional line items (including by disaggregating the line items listed in paragraph 54) when such presentation is relevant to an understanding of the entity's financial position. Consequently, an entity is required to determine whether to present liabilities that are part of a reverse factoring arrangement:

a. within trade and other payables;

b. within other financial liabilities; or

c. as a line item separate from other items in its statement of financial position.

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 liabilities that are part of a reverse factoring arrangement:

a. as part of 'trade and other payables' only when those liabilities have a similar nature and function to trade payables—for example, when those liabilities are part of the working capital used in the entity's normal operating cycle.

b. 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 it is required 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. the extent to which the terms of liabilities that are part of the arrangement differ from the terms of the entity's trade payables that are not part of the arrangement.

Derecognition of a financial liability

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 *Financial Instruments*.

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').

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 how to classify cash flows under the arrangement, typically 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 whether the related cash flows arise 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 inflow or cash outflow occurs for an entity in a financing transaction, 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).

Notes to the financial statements

Paragraph 31 of IFRS 7 *Financial Instruments: Disclosures* requires an entity to provide 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. IFRS 7 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 might have to pay a significant amount, at one time, to one counterparty.

b. the entity may have become reliant on extended payment terms or the entity's supplier may have become accustomed to, or reliant on, earlier payment under the reverse factoring arrangement. If the financial institution were to withdraw the reverse factoring arrangement, that withdrawal could affect the entity's ability to settle liabilities when they are due, 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 the 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.

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.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine the presentation of liabilities that are part of reverse factoring arrangements, the presentation of the related cash flows, and the information to disclose in the notes about, for example, liquidity risks that arise in such arrangements. Consequently, the Committee decided not to add a standard-setting project on these matters to the work plan.