

IFRS Developments

Agenda Decision on reverse factoring

What you need to know

- ▶ In an Agenda Decision issued in December 2020, the IFRS IC concluded that IFRS Standards provide an adequate basis to determine the presentation of liabilities and the associated cash flows in reverse factoring arrangements.
- ▶ Entities undertaking reverse factoring arrangements should ensure that disclosures provided are sufficient to meet users' needs.

Background

On 14 December 2020, the International Accounting Standards Board (the IASB or the Board) met to determine whether to publish the IFRS Interpretations Committee's (the IFRS IC or the Committee) Agenda Decision *Supply Chain Financing Arrangements - Reverse Factoring* (the Agenda Decision) in accordance with the new due process for agenda decisions. No members of the Board objected, and the Agenda Decision was published in December 2020.

The Agenda Decision considers the impact of a reverse factoring arrangement on presentation in the balance sheet, the derecognition of a financial liability, presentation in the statement of cash flows and in the notes to the financial statements.

Whilst reverse factoring arrangements are not new, they have gained more prominence in recent years. There are many variations of reverse factoring arrangements. In the Agenda Decision, arrangements in which "*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*" are addressed.

The Issues

In the submission, the Committee was asked two questions:

- ▶ How does an entity present liabilities to pay for goods or services received when the related invoices are part of a reverse factoring arrangement?
- ▶ What information about reverse factoring arrangements is an entity required to disclose in its financial statements?

In responding to the first question, the Committee addressed presentation both in the statement of the financial position and in the statement of cash flows.

Presentation in the statement of financial position

A trade payable represents a liability to pay for goods or services, is invoiced or formally agreed with the supplier, and is part of the working capital used in the entity's normal operating cycle.

Trade and other payables are sufficiently different in nature or function from other financial liabilities, such that IAS 1 *Presentation of Financial Statements* indicates that they warrant separate presentation. It may also be appropriate to further disaggregate trade and other payables if this improves the understanding of the entity's financial position. As a result, an entity needs to determine whether to present liabilities in reverse factoring arrangements:

- ▶ Within trade and other payables
- ▶ Within other financial liabilities
- Or
- ▶ As a line item separate from other items in its statement of financial position

Trade payables are defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as "liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier". Furthermore, IAS 1 explains that trade payables "are part of the working capital used in the entity's normal operating cycle".

As a result, the Committee concluded that an entity presents a financial liability as a trade payable only when it:

- ▶ Represents a liability to pay for goods or services
- ▶ Is invoiced or formally agreed with the supplier
- And
- ▶ Is part of the working capital used in the entity's normal operating cycle

IAS 1 requires items that are dissimilar in nature or function to be presented separately in an entity's financial statements. The aggregation of items within a line item in the financial statements is permissible if it does not detract from the understanding of the financial statements.

Accordingly, the Committee concluded that liabilities that are part of a reverse factoring arrangement are presented:

- ▶ As part of 'trade and other payables' only when those liabilities have a similar nature and function to trade payables
- Or
- ▶ Separately when the size, nature or function of those liabilities makes separate presentation relevant to an understanding of the entity's financial position, considering the amounts, nature and timing of those liabilities

In assessing the presentation of liabilities that are part of a reverse factoring arrangement, the Committee noted that aspects to consider may include whether additional security is provided as part of the arrangement and the extent of the difference in the terms of the arrangements.

Furthermore, the Committee noted that entities need to assess whether and when to derecognise trade payables that are part of reverse factoring arrangements by applying the derecognition requirements of IFRS 9 *Financial Instruments*. The guidance summarised above also applies when determining the appropriate presentation of the corresponding liability recognised in those cases in which a trade payable is derecognised.

Presentation in the statement of cash flows

The cash flows in a reverse factoring arrangement will typically be classified as either cash flows from operating activities or cash flows from financing activities, both of which are defined in IAS 7 *Statement of Cash Flows*. The Committee noted that the classification of the liability in the statement of financial position may help in determining whether the associated cash flows are from operating or financing activities. For example, an assessment that the liability meets the requirements for presentation as a trade or other payable suggests that the associated cash flows are those from operating activities. Conversely, if the classification of the liability is not a trade or other payable, the associated cash flows are presented as cash flows from financing activities.

The Agenda Decision does not go beyond acknowledging that, generally, there may be reverse factoring arrangements in which there are cash flows arising on the factoring of an invoice.

One issue that arises in practice, is whether the remittance of cash directly to the supplier by the financial institution should be reflected at all in the statement of cash flows of the entity, or whether it is to be considered a non-cash transaction. The Agenda Decision does not go beyond acknowledging that, generally, there may be reverse factoring arrangements in which there are cash flows arising on the factoring of an invoice: *"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."*

Notes to the financial statements

IFRS 7 *Financial Instruments: Disclosures* requires disclosures to enable users to evaluate the nature and extent of risks, including liquidity risk, arising from financial instruments. The Committee observed that liquidity risk may arise from entering into reverse factoring arrangements as a result of liabilities being concentrated with one financial institution rather than with a diverse group of suppliers. Furthermore, an entity may become reliant on the extended payment terms of a reverse factoring arrangement, which, if the arrangement is subsequently withdrawn, may lead to an inability to settle liabilities when they are due to the suppliers.

IAS 7 requires *"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 disclosures are 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.

Entities will need to apply judgement to determine if additional disclosures are required to ensure that the effects of reverse factoring arrangements are adequately disclosed. The Committee observed that, under IAS 1:

- ▶ Assessing how to present liabilities and cash flows related to reverse factoring arrangements may involve judgement which will require certain disclosures
And
- ▶ Reverse factoring arrangements may have a material effect on an entity's financial statements, and an entity should provide information to the extent that it is relevant to an understanding of its financial statements

The Committee's conclusion

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 which information to disclose in the notes. Consequently, the Committee decided not to add a standard-setting project on these matters to the work plan.

How we see it

The Agenda Decision provides entities with guidance as to when liabilities associated with reverse factoring arrangements should be recognised as trade or other payables or financial liabilities.

The clarification of the consequential impact on the statement of cash flows is also helpful. However, the Agenda Decision states the obvious, when it confirms that if no cash flows are involved, then no cash flows should be presented in the cash flow statement. In practice, it has been observed that certain entities consider that the relationship between themselves and the financial institution is, in substance, a principal/agent relationship. Such an assessment would imply that the financial institution is acting as an agent of the entity and is, therefore, incurring cash flows on behalf of the entity when paying the supplier. It is unclear from the Agenda Decision whether such an analysis would be appropriate. Entities will, therefore, need to apply judgement and consider the facts and circumstances when determining the appropriate impact on the cash flow statement.

Furthermore, the Agenda Decision's reminder about the need to provide disclosures reflecting the impact of reverse factoring arrangements on liquidity risk and financing cash flows, if applicable, is helpful. Also, it is key that entities disclose the judgement applied in determining the appropriate presentation in the statement of financial position and the statement of cash flows, when it is required in order to ensure that users of financial statements can evaluate the impact of these arrangements, when the impact is material.

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ED None

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