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Clarity in financial reporting

Implications of supplier finance arrangements on trade payable

Talking Points

- Supplier finance arrangements are varied in nature and do not necessarily refer to one single type of contractual arrangement but usually involve a bank making payments to the supplier of goods or services and receiving money from the purchaser of those goods and services rather than the payments being made directly between the supplier and purchaser.
- After entering into a supplier finance arrangement, careful consideration is required to determine whether the financial liability should continue to be presented as a trade payable or whether it should be presented as part of borrowings. This could impact gearing and leverage ratios.
- If presentation as a trade payable is no longer appropriate, the classification of the associated cash outflows in the Statement of Cash Flows will also change from operating to financing activities.
- The appropriate presentation of supplier finance arrangements in the financial statements will require significant judgement based on the facts and circumstances for each arrangement. Where the arrangements are material, additional disclosures will be required to explain the judgements and accounting policy applied.

For more information please see the following websites:

www.iasplus.com

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What are supplier finance arrangements?
An entity that buys goods and services on credit ('purchaser') may enter into arrangements with a bank whereby the bank agrees to make payments to the supplier of the goods and service ('supplier') and the purchaser makes a payment to the bank. Such arrangements have various names including 'supplier finance', 'supplier-chain finance', 'reverse factoring', trade finance and vendor financing (for the purpose of this document the arrangements are collectively referred to as supplier finance).

The rationale for entering into supplier finance may include:

- The purchaser pays the bank later than the purchaser would have paid its supplier (the purchaser thereby benefitting from extended payment terms to improve working capital but at a cost that is payable to the bank).
- Improved administration of supplier payments for the purchaser as amounts are paid to the bank only and not to multiple suppliers.
- The supplier is paid earlier by the bank than it would have been paid by the purchaser (the supplier accepting an early payment discount). The early payment discount the supplier accepts from the bank is usually less than the interest cost it would have incurred had the supplier instead borrowed from a bank (as the amount of the discount is driven by the credit quality of the purchaser, not the supplier).

Although the specific terms and conditions of supplier finance vary, they may include:

- The purchaser instigates the programme and selects the supplier and/or supplier invoices that are subject to the arrangement.
- The arrangement continues to be applied for future invoices arising with selected suppliers.
- The bank offers the supplier early payment or allows the supplier to borrow from the bank secured on the future payment due from the purchaser.
- The bank will enforce its rights to receive interest should the purchaser pay the bank late (often in a typical purchaser and supplier relationship late payment from the purchaser to the supplier does not result in the supplier enforcing any contractual or statutory right to charge the purchaser interest on late payments).
- The bank takes on the credit risk of the purchaser and makes a profit from charging the purchaser interest on extended finance, charging the purchaser fees, and/or overall making a return from paying the supplier less (through an early payment discount) than it recovers from the amount due from the purchaser.

Who is impacted?
All entities who are considering entering into a supplier finance arrangement should consider the impact of such an arrangement on their financial statements.

Why do supplier finance arrangements create an issue?
Trade payables typically represent obligations to suppliers in the ordinary course of business. A purchaser would not typically present liabilities to a financial institution such as a bank as trade payables.

Consequently, the key consideration is whether a supplier finance arrangement should result in the purchaser presenting the financial liability as a borrowing rather than a trade payable.

The presentation of the financial liability matters as it may have significant impacts on the purchaser's financial position, particularly its leverage and gearing ratios and disclosures around financing activities. Furthermore, existing borrowing arrangements of the purchaser may restrict its ability to borrow from alternative sources or take on incremental borrowings without the approval of the purchaser's principal lenders.

What do the Accounting Standards tell us?
Australian Accounting Standards (AASBs) and International Financial Reporting Standards (IFRSs) do not specifically address supplier finance. However, there is some guidance in the Accounting Standards that is helpful in determining the most appropriate presentation.

First and foremost, AASB 101 Presentation of Financial Statements provides a useful description of trade payables, stating that: *"Some current liabilities, such a trade payables and some accruals for employee and other operating costs, are part of working capital used in the entity's normal operating cycle."*

Therefore, in determining the appropriate line item in the statement of financial position the purchaser should compare the terms of its obligations under the supplier finance arrangement with the typical terms of its obligations to suppliers in the absence of a supplier finance arrangement. Where the substance of the contractual terms of the arrangement does not differ and therefore the amounts owed to the bank are akin to amounts owed to the supplier, the purchaser may consider such obligations as being part of its normal operating cycle and disclose amounts due as trade payables. However, all facts and circumstances should be considered very carefully. The differences in contractual terms can be very sensitive. For example, a change from 30 day credit terms to 60 day credit terms may, in some situations, be sufficient to change the substance of the arrangement.

It is also critical to understand the purpose of introducing of a supplier finance arrangement.

For example, a purchaser and supplier might enter into a supplier finance arrangement as the means by which the purchaser assists the supplier in obtaining affordable finance (i.e. the purchaser's liability is still a trade payable). In such instances, the purchaser typically acts as an agent in introducing the key suppliers to the bank and it is the supplier who typically negotiates the terms. On the other hand, a purchaser might enter into a supplier finance arrangement to improve its working capital position (i.e. the purchaser is obtaining additional financing). In such instances, the purchaser typically selects which suppliers should be part of the arrangement and negotiates the interest rates and terms with the bank on its own behalf, suggesting that the arrangement represents borrowings rather than trade payables.

Once the substance of the transaction is understood, the presentation as a trade payable or a borrowing should follow the substance. However, this will often not be a clear-cut assessment and significant judgement will be required based on specific facts and circumstances.

A helpful starting point to determine if entering into a supplier finance arrangement has modified the substance of the liability is the derecognition guidance in AASB 139 Financial Instruments: *Recognition and Measurement* or AASB 9 *Financial Instruments*. AASB 139 and AASB 9 require a financial liability to be considered extinguished if, as a result of a modification or an exchange of instruments, the terms of the instruments are substantially different. In other words, if the derecognition guidance indicates that the original liability has been substantially modified, it could be indicative that the nature of the original liability has changed from that of a trade payable to bank borrowings as a result of the supplier finance arrangement.

Further factors to consider
Below are some other factors to consider:

- **Extended credit terms:** as a result of entering into the supplier finance arrangement, the payment terms may be substantially modified such that the purchaser pays the bank later then they could have paid the supplier under the original supply arrangement with the supplier. For derecognition purposes, the purchaser would have to consider whether the extended credit terms are indicative that the original financial liability has been substantially modified (i.e. extinguished). To the extent that extended credit terms are not available to the purchaser under normal trading conditions it could be indicative that the liability is not part of the entity's normal operating cycle but is instead additional funding. For example, a specific supplier might have a policy of providing credit terms of up to a maximum of 30 days. If a purchaser enters into an arrangement that extends the terms beyond the maximum 30 days (for example 60 days) it could be indicative that the liability represents funding.

- **Legal novation:** as a result of entering into the supplier finance arrangement, the trade payable may be legally extinguished from the perspective of the purchaser. Legal novation of the obligation as being due to the bank rather than to the supplier is indicative that the original liability has been extinguished. Careful consideration would be required to understand the extent to which the rights and obligations attached to the original liability are different as a result of entering into the supplier finance arrangement (for example how credit notes are dealt with, what recourse exists in the case of default of a party etc.). To the extent that the rights and obligations are not different from those previously held, this could be indicative that the nature of the liability remains the same i.e. trade payable.

- **Additional credit enhancements:** as a result of entering into the supplier finance arrangement, the parent of the purchaser may provide additional security (e.g. guarantees) to the bank that is not generally available to the supplier in the absence of the arrangement. Additional credit enhancements may be indicative that the original liability has been extinguished and that the nature of the liability is more akin to debt as opposed to a trade payable.

- **Impact on other lines of credit held with a bank:** as a result of entering into the supplier finance arrangement, a bank could consider each trade payable bought as a drawdown on an existing line of credit or it could reduce the availability of other loan commitments from the bank. The fact that the supplier arrangement creates a link to existing lines of credit could indicate that the terms of the payables have been substantially modified. The terms and conditions would need to be considered carefully as the drawdown of a credit facility would not necessarily align with the nature of a trade payable.

All facts and circumstances would need to be assessed. The above list is not intended to be an exhaustive list of indicators to consider.

What are the consequences for the Cash Flow Statement?
AASB 107 *Statement of Cash Flows* does not provide specific guidance on supplier finance arrangements. Consequently, the general requirements of AASB 107 must be applied in determining whether the cash flows are operating or financing. When the presentation of a liability as a trade payable is considered to be unaffected by a supplier finance arrangement, cash outflows that extinguish the obligation are presented as operating cash flows.

On the other hand, if the original financial liability is extinguished, as the nature of the purchase is no longer considered a trade payable, the new financial liability to the bank is presented with other borrowings. Consequently, cash outflows that extinguish the financial liability should be presented as a financing cash flow. Where this is the case sufficient disclosures will need to be made in the financial statements to ensure that users understand why cash flows from operating activities are higher than in prior years (when the cash outflow would have been shown as an operating cash flow).

What are some of the disclosure requirements?
A further illustration of the importance of determining the appropriate presentation of the financial liability (i.e. as either trade payables or borrowings) is the recently issued amendments to AASB 107 with regard to disclosures around changes in liabilities from financing activities. These disclosure requirements are effective for annual periods beginning on or after 1 January 2017.

In accordance with these requirements, an entity should provide disclosures that enable users to evaluate changes in liabilities arising from financing activities (as defined by AASB 107), including both changes arising from cash flows and non-cash flows. If, as a result of the supplier finance arrangement, the financial liability is considered a borrowing rather than a trade payable, changes in that liability (from the opening to closing balance in the Statement of Financial Position) will be subject to this new disclosure requirement around changes in liabilities from financing activities.

In addition, to the extent that the presentation of the supplier finance arrangement is material to an understanding of the financial statements, an entity should disclose the relevant significant accounting judgements used in arriving at a particular conclusion, in accordance with AASB 101.

Conclusion
In practice, the impact of a supplier finance arrangement on the presentation of a financial liability is likely to involve a high degree of judgement based on specific facts and circumstances. Whatever the presentation adopted, additional disclosures will often be necessary to explain the nature of the arrangements and the financial reporting judgements made.

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