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A&A Accounting Technical

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Clarity in financial reporting

Implications of supplier finance arrangements on trade payables

CONTENT

Talking points

- A purchaser of goods or services may enter into a variety of arrangements to fund its payables to the supplier. For example, a bank pays the supplier directly, with the purchaser then reimbursing the bank at a later date.
- After entering into a supplier finance arrangement, careful consideration is required to determine whether the financial liability should be presented as a trade payable or whether it should be presented as part of borrowings. This could impact key performance ratios and influence users' understanding of the purchaser's financial position, debt and cash flows.
- 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 to reflect a financing cash outflow.
- 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, it is important that additional disclosures are provided to explain the judgements and accounting policy applied.

For more information please see the following websites:

www.iasplus.com

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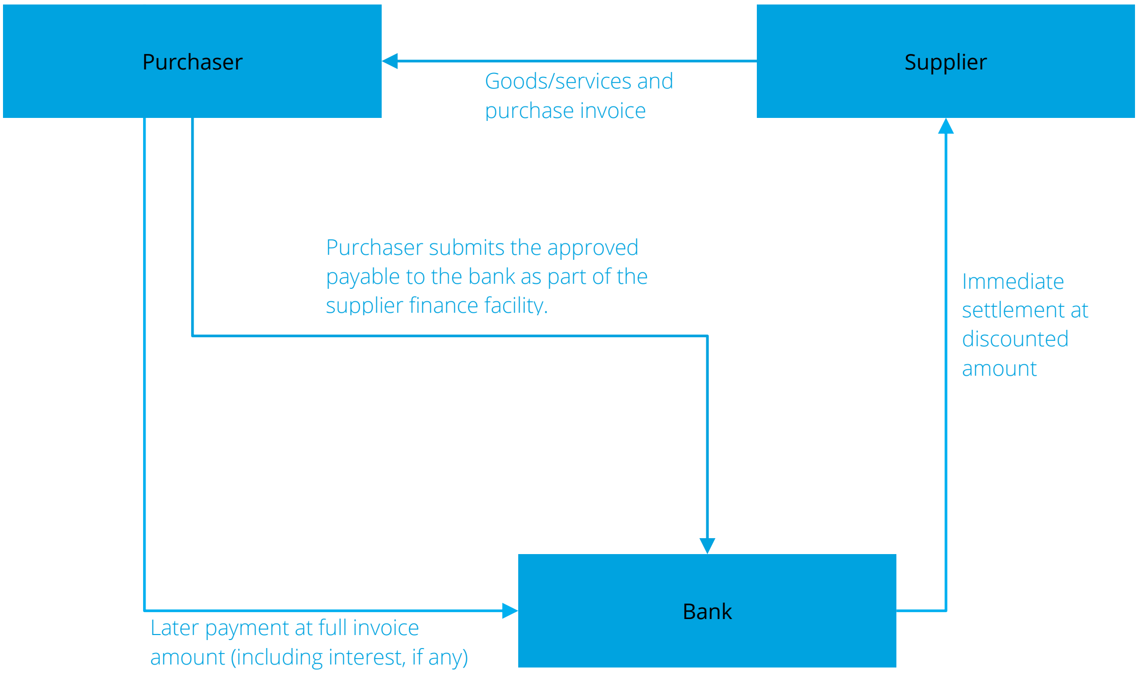
What are supplier finance arrangements?

An entity that buys goods and services on credit (the 'purchaser') may enter into arrangements with a bank whereby the bank agrees to make a payment to the supplier of the goods and service ('the supplier') and the purchaser makes a payment to the bank. Such arrangements have various names including 'supplier finance', 'supply chain finance', 'reverse factoring', 'payables service agreements', '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).
- Improved administration of supplier payments for the purchaser as amounts are paid to the bank only and not to multiple suppliers.
- The supplier may be paid earlier by the bank than it would have been paid by the purchaser.
- Allows the supplier to, effectively, access finance based on the purchaser's credit rating (which may be better than its own). The early payment discount the supplier extends to 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).
- Strengthening business relationships between the purchaser and the supplier.
- The purchaser can negotiate early settlement discounts with 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 that have entered into or are considering entering into a supplier finance arrangement should consider the impact of such an arrangement on their financial statements, both in terms of presentation and disclosure.

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.

Disclosure of borrowings and their related cash flows allow users of financial statements to assess the general health and liquidity risks of an entity. When a purchaser's payment terms are extended under a supplier finance arrangement it paints a very different picture to users of financial statements if they are described as trade payables as opposed to borrowings. Consequently, the correct characterisation of the liability in the statement of financial position and disclosure around these arrangements are crucial.

Commentary from Moody's in March 2018 on the collapsed UK construction company Carillion illustrates the concern:

"Carillion's approach to its reverse factoring had two key shortcomings: the scale of the liability to banks was not evident from the balance sheet, and a key source of the cash generated by the business was not clear from the cash flow statement." - Trevor Pijper, a Moody's Vice President – Senior Credit Officer

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* (AASB 101) requires that the statement of financial position include line items that present the following, including:

- Trade and other payables
- Financial liabilities (excluding trade and other payables and provisions).

AASB 101.70 also provides a useful description of trade payables, stating that: *"Some current liabilities, such as trade payables and some accruals for employee and other operating costs, are part of working capital used in the entity's normal operating cycle."* Furthermore, paragraph 11 of AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* describes trade payables as *"liabilities to pay for goods and services that have been received or supplied and have been invoiced or formally agreed with the supplier"*.

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 which are not subject to a supplier finance arrangement. Where the substance of the contractual terms of the arrangement, including the payment terms, do 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 a 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 trade payables or borrowings 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.

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 than they would have paid the supplier under the original supply arrangement with the supplier. 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 or 120 days) it could be indicative that the liability represents funding. The cost of extending the term could be another indication that the nature of the liability might have changed. For example, the cost of the extended term could be more consistent with the purchaser's general borrowing rates from financial institutions rather than with rates payable on overdue invoices from its suppliers.

- **Legal novation and contractual relationship:** as a result of entering into the supplier finance arrangement, the trade payable may be legally extinguished from the perspective of the purchaser when the supplier is paid cash by the bank. A legal extinguishment could be indicative of a change in the nature of the underlying liability. Careful consideration would be required to understand the extent to which the rights and obligations under the contractual relationship attached to the original liability are different as a result of entering into the supplier finance arrangement. For example, whether the supplier retains recourse to the purchaser in the event that the bank fails to make a payment when contractually due. Another example could be whether the purchaser retains any right to withhold payment to the bank if goods from the supplier are found to be faulty. To the extent that the contractual 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 purchaser or parent of the purchaser may provide additional security (e.g. guarantees or collateral) 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* (AASB 107) 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. This is because the liability forms part of the purchaser's working capital and could be considered to arise (originally) from the purchase of goods or services.

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. This may be problematic since it results in no cash outflow representing the purchase of goods or services. This presentation would, therefore, need to be accompanied by clear disclosure of a non-cash transaction (i.e. the drawdown of borrowings in exchange for the bank taking on a trade payable liability) 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).

To address this concern, it may also be acceptable to apply a 'gross' presentation of an operating cash outflow and financing cash inflow as the supplier receives cash (legally) from the bank. Particularly if, as may be the case, the arrangement is governed by a tripartite agreement and the purchaser's legal liability to the supplier is not legally extinguished at this time then the arrangement can be viewed as the purchaser making a payment to its supplier and simultaneously drawing down a loan from the bank who is simply acting as an intermediary between the two parties. Following this approach, the subsequent payment to the bank is presented as a normal financing cash outflow on repayment of a borrowing.

Whichever approach is adopted, it is important that the accounting policy adopted is clearly explained and that any non-cash financing transactions are disclosed.

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 requirements in paragraphs 44A to 44E of 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 paragraphs 122 to 124 of AASB 101.

In circumstances where an entity determines its liability is not like a borrowing and it remains classified as trade payables, it should consider whether disaggregation of the amounts within 'trade payables' is needed. In other words, entities should determine whether it is necessary to distinguish amounts owed to suppliers in relation to the purchase of goods and services from amounts arising from such purchases that are now due to a bank. Such disaggregation may be provided on the face of the statement of financial position or in the notes to the financial statements.

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 the specific facts and circumstances. Whichever presentation is adopted, management should carefully consider the additional disclosures that will be necessary to explain the nature of the arrangements and the financial reporting judgements made.

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