Chapter 2

Supplier finance arrangements: Proposed amendments to IAS 7 and IFRS 7

This article aims to:

Expound the amendments proposed by IASB on disclosures required for supplier finance arrangements.

Introduction

Globally, there has been an increase in the usage of supplier financing arrangements[1] as a means to improve working capital position. However, currently, there is no explicit guidance on accounting for supplier finance arrangements. In this regard, the IFRS Interpretations Committee (IFRIC) received a request regarding the information which is required to be provided in financial statements about supply chain finance (reverse factoring) arrangements.

In response to this, in December 2020, IFRIC through an agenda decision[2] concluded that the IFRS standards already provide adequate basis to determine the presentation of liabilities and associated cash flows that meet some of the information needs of users of financial statements with respect to reverse factoring arrangements.

However, based on the several suggestions and inputs received from investors, analysts and users of financial statements, the International Accounting Standards Board (IASB) opined that without targeted amendments to the current disclosure requirements, users of financial statements might not be able to obtain some of the information they need to understand the effects of the supplier finance arrangements and may, therefore, face challenge in comparing one entity with another. Thus, the IASB through an Exposure Draft: Supplier Finance Arrangement (the Exposure Draft) issued in November 2021, proposed amendments to IAS 7, *Statement of Cash Flows* and IFRS 7, *Financial Instruments: Disclosures.* The proposals add disclosure requirements related to supplier finance arrangements in order to meet the user information needs in a way that complements the current requirements in IFRS standards. The comment period for this Exposure Draft ends on 28 March 2022.

In this article, we aim to provide an overview of the accounting provisions applicable to supplier finance arrangements and disclosures proposed by IASB in its Exposure Draft.

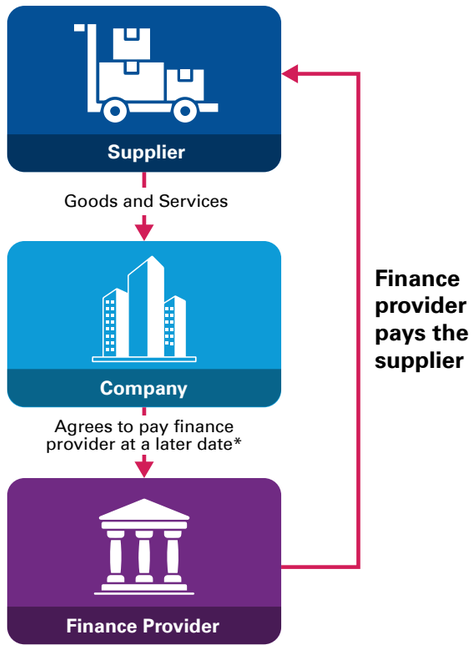
Understanding supplier finance arrangements

An entity may enter into supplier finance arrangements for different reasons, such as to improve working capital position, assist the entity's suppliers through alternative and more affordable financing, etc. The IASB's proposals apply to supplier finance arrangement, which have the following characteristics:

- The finance provider[3] pays amounts a company (the buyer) owes its suppliers
- The company agrees to pay the finance provider at the same date as, or a date later than, suppliers are paid, and
- The company is provided with extended payment terms or suppliers benefit from early payment terms, compared with the related invoice payment due date.

This arrangement is depicted in figure 1 below:

Figure 1: Supply finance arrangement



*At the same date as, or a date later than, suppliers are paid

(Source: Exposure Draft on Supplier Finance Arrangement issued by IASB in November 2021)

1. Also referred to as supply chain finance, payables finance or reverse factoring arrangement.
2. Agenda Decision, Supply Chain Financing Arrangements-Reverse Factoring.
3. Also referred to as 'factor'.

All arrangements with the characteristics of supplier finance arrangements (as mentioned above) are subject to the proposed disclosure requirements. However, the terms and conditions of supplier finance arrangements can range from simple to highly complex and arrangements can vary in form and how they are labelled.

The Exposure Draft specifies that the proposals do not apply to arrangements for financing receivables or inventory.

IFRIC Agenda Decision - Accounting for supplier finance arrangements – an overview

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. Determining this aspect is critical as it could impact key performance ratios and user's understanding of the purchaser's financial position and cash flows.

IFRIC, in its agenda decision specified that the IFRS standards provide adequate guidance to determine presentation of liabilities and cash flows in the financial statements. Thus, the presentation of the supplier finance arrangements and the cash flows are evaluated as under:

Presentation in the balance sheet

Derecognition of trade payables

Entities would need to evaluate the arrangement entered into to determine whether it results in derecognition of a trade payable to a supplier and recognition of a new financial lability to a financial institution, applying the derecognition provisions prescribed in IFRS 9, *Financial Instruments*. In such a case, the entity should refer to IAS 1, *Presentation of Financial Statements* for disclosure of the new liability in the balance sheet.

Presentation in balance sheet

As per IAS 1, an entity is required to evaluate whether to present liabilities that are part of a reverse factoring arrangement:

- Within trade and other payables
- Within other financial liabilities, or
- As a line item separate from other items in its statement of financial position[4].

In making this determination, entities would need to assess the substance of supplier finance arrangements. Where the terms of the liabilities (including the nature and function of the liabilities) entered into are similar to the terms of an entity's trade payables[5] (for example, when those liabilities are part of the working capital used in the entity's normal operating cycle), they would be classified as a trade payable. Other factors should also be assessed, for example, where an entity provides additional security as part of the supplier finance arrangement, that would not have been provided without the arrangement, then the liability would not represent trade payables. Further, entities may determine to disclose these liabilities separately in the balance sheet, when the size, nature or function of such liabilities make separate presentation relevant to an understanding of the entity's financial position.

Companies are required to disclose the accounting policy they apply to the liabilities arising from or affected by supplier finance arrangements.

Presentation in the statement of cash flows

IAS 7 does not provide specific guidance on supplier finance arrangements, however, IFRIC 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 as a trade or other payable, the entity presents cash outflows to settle the liability as arising from operating activities in its statement of cash flows. Where the related liability represents borrowings, the entity presents cash outflows to settle the liability arising from financing activities in its statement of cash flows.

Where entities determine that the liability arising from the supplier finance arrangement results in a borrowing, it would result in a non-cash transfer of liabilities within the balance sheet. IAS 7 requires an entity to provide disclosures that enable users of financial statements to evaluate changes in liabilities (both, cash and non-cash changes) arising from financing activities.

Exposure Draft - Key requirements

The Exposure Draft proposes to introduce as a new disclosure objective in IAS 7 for a company to provide information about its supplier finance arrangements. This would enable users (investors) to assess the effects of these arrangements on the company's liabilities and cash flows.

4. As per IAS 1, an entity will present additional line items (including by disaggregating line items in the balance sheet) when such presentation is relevant to an understanding of the entity's financial position.
5. As per IAS 37, Provisions, Contingent Liabilities and Contingent Assets, 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.

Disclosure requirements proposed by the Exposure Draft

The amendments proposed in the Exposure Draft require entities to disclose additional information in the notes to the financial statements about those arrangements that would enable users to assess the effects of these arrangements on the company's financial statements. These are given as under:

Amendments to IAS 7

Following are an illustrative set of additional disclosures that an entity would now be required to provide as per IAS 7.

Example: Supplier finance arrangement with Finance Provider A		
Qualitative information		
[Disclosure of terms and conditions (e.g., extended payment terms and security or guarantees provided.)]		
Quantitative information		
Nature of disclosure	**End of reporting period 31 December 20X1**	**Beginning of reporting period 1 January 20X1**
For each supplier finance arrangement,		
i. The carrying amount of financial liabilities recognised in the entity's balance sheet that are part of the arrangement and the line item(s) in which those financial liabilities are presented, together with the entity's accounting policies	2,000 (disclosed under trade and other payables)	1,500 (disclosed under trade and other payables)
ii. The carrying amount of financial liabilities disclosed under (i) for which suppliers have already received payment from the finance providers	1,500	1,100
iii. The range of payment due dates of financial liabilities disclosed under (i)	XX-YY days after invoice date	YY-ZZ days after invoice date
The range of payment due dates of trade payables that are not part of a supplier finance arrangement as at the beginning and end of the reporting period	AA-BB days after invoice date	CC-DD days after invoice date

(Note: An entity would be permitted to aggregate the information provided for different arrangements only when the terms and conditions of those arrangements are similar.)

(Source: KPMG in India's analysis, 2022 read with Disclosure of supplier finance arrangements, issued by KPMG IFRG Limited, 2021)

Amendments to IFRS 7

Reverse factoring arrangements often give rise to liquidity risk. By entering into such an arrangement, an entity concentrates a portion of its liabilities with one or a few finance providers. Consequently, if the arrangement gets withdrawn during times of stress, it could increase pressure on an entity's cash flows and affect its ability to settle liabilities when they are due. In another situation, suppliers may be inclined to renegotiate payment terms with customers in times of stress, however finance providers, subject to capital requirements may not be inclined to be as flexible.

Thus, users of financial statements need information to help them assess the effect of supplier finance arrangements on an entity's exposure to liquidity risk and risk management. As a part of the Agenda Decision, IFRIC was of the opinion that the liquidity risk disclosure requirements in IFRS 7 were comprehensive enough to meet the information needs of the users of financial statements. Under the existing set of requirements of IFRS 7, an entity is required to make certain quantitative disclosures in order to disclose the nature and extent of risks arising from financial instruments. A key disclosure under these quantitative disclosures is disclosure of liquidity risk. As a part of the proposed amendments, **supplier finance arrangements have been added as an example within the liquidity risk disclosure requirements**[6].

Transition

Entities already applying IFRS standards

IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* requires an entity to initially apply an IFRS Standard (or amendments to it) retrospectively, except to the extent it is impracticable to do so.

Thus, IASB has decided that entities would be required to apply the proposed amendments retrospectively in accordance with IAS 8. However, the effective date would be decided after the deadline of the exposure draft. Earlier application would be permitted. If an entity applies the amendments for an earlier period, it would be required to disclose that fact.

Next steps

With supplier finance arrangements becoming a more prevalent source of financing in recent years, expectations of the users of financial statements with respect to a more detailed and transparent disclosure of information of such arrangements have also increased many fold. Without detailed disclosure of information about an entity's supplier finance arrangements, users face a stern challenge in:

a. Analysing the total amount and terms of an entity's debt,

b. Identifying operating and financing cash flows arising from supplier finance arrangements,

c. Understanding the effect supplier finance arrangements have on an entity's exposure to liquidity risk; and

d. Comparing the financial statements of an entity that uses supplier finance arrangements with those of an entity that does not.

According to IASB, additional information that is now required to be disclosed is already readily available with the entities and consequently, application of the new requirements would not result in significant costs for the entities affected. However, for some supplier finance arrangements, the information a company might need to meet certain of the new disclosure requirements may not always be readily available, it should thus obtain this information from its finance providers.

The Indian Accounting Standards (Ind AS) are based on the IFRS standards issued by IASB, thus amendments to IFRS will be adopted (with or without modification) within Ind AS. On that account, entities in India, that would be impacted by the proposals issued by IASB are encouraged to raise their concerns or provide their suggestions to the IASB.

6. These provisions have been added under para B11F of IFRS 7 which provides the factors that an entity might consider in providing the disclosure required in para 39(c) (i.e., description of how it manages the liquidity risk inherent in the maturity analysis of non-derivative and derivative financial liabilities).