# IASB Supplier Finance Arrangements Exposure Draft

## Investment Association Response

### About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 270 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £9.4 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 44% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

### Executive summary

The IA welcomes the opportunity to input into the International Accounting Standards Board's (IASB) consultation on proposed Amendments to IAS 7 and IFRS 7 concerning supply chain financing arrangements (reverse factoring).

The IA has previously stated concerns about the prevalence of reverse factoring, and the lack of transparency of those arrangements in our response to the IASB Third Agenda consultation. We therefore welcome the IASB's proposals to enhance the disclosures that companies are required to make on these arrangements.

We are pleased to see the IASB is proposing to provide further clarity on IFRS standards that apply to reverse factoring. Despite reverse factoring arrangements being a debt-like liability, these arrangements are not accounted for as financial debt and therefore are not disclosed in the notes to the accounts. The information asymmetry between the finance providers, banks and investors created by current insufficient disclosures on reverse factoring undermines the integrity of the market.

A recent study[1] by the Supply Chain Finance Community and PwC provides an insight into the frequency of these arrangements. According to the study, 49% of companies surveyed operate a reverse factoring programme, yet, according to Moody's research[2] fewer than 5% disclose such a programme in their public accounts. The study confirms that reverse factoring is widespread and very rarely disclosed.

Whilst we recognise that reverse factoring is not a 'bad' method of credit, there are several issues for investors when arrangements are not disclosed:

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[1] https://www.pwc.com/vn/en/deals/assets/scf-barometer-2018-2019.pdf

[2] https://www.ifrs.org/content/dam/ifrs/meetings/2020/april/ifric/ap03-supply-chain-financing.pdf, https://www.moodys.com/research/Moodys-Reverse-factorings-rising-popularity-comes-with-high-but-hidden--PBC_1195322

- The lack of disclosure of these liabilities results in under-reported financial debt. This is troubling for both credit investors, as they are unaware of the additional leverage funded through such arrangements, and equity investors, as under reported financial debt might translate into inflated market equity valuations. Therefore, when such arrangements are not disclosed, investors may misallocate capital, by mispricing credit risk and over valuing stocks.
- Default risk is a key consideration for investors and the risk can be exacerbated by these arrangements, which are generally short-term in nature and can be removed at short notice. When finance providers remove these lines, the resulting working capital shock can potentially trigger a liquidity crisis that could lead to the issuer's default, without any warning sign for investors. When these arrangements are not disclosed, investors are unaware of this additional source of default risk, compounding the capital allocation and pricing challenge described in the previous point.
- When these arrangements are not disclosed, finance providers have an asymmetrical information advantage vs. debt capital market investors which undermines a key tenet of efficient capital markets (i.e., that the same information is made available to all investors).

Conventional non-recourse receivables factoring represents less of a risk from a liquidity perspective as it is a secured form of funding linked to the credit quality of the borrower's customers, rather than the credit quality of the borrower itself, as for reverse factoring.

We therefore welcome the proposed Amendments to IAS 7 to ensure investors receive transparency on a company's financial debts. The proposed Amendments will provide investors with greater visibility on the additional leverage funded through such arrangements.

Finally, we would like to extend our support by suggesting an additional recommendation, to which we believe will provide further transparency of reverse factoring arrangements. The IA proposes that under paragraph 44H of the [Draft] Amendments to IAS 7, a reporting requirement of average arrangements used over the financial year is disclosed. IA members are concerned with the proposed additional disclosures being required at the end of the reporting period. The current reporting deadline poses the threat of 'window dressing' if companies halt arrangements before the end of the reporting period to avoid being required to provide disclosures. Implementing an average position on supply chain financing liabilities over the reporting period would therefore give investors an even clearer view of the use of these arrangements during the year.

## Question 1 – Scope of disclosure requirements

The [Draft] Amendments to IAS 7 and IFRS 7 do not propose to define supplier finance arrangements. Instead, paragraph 44G of the [Draft] Amendments to IAS 7 describes the characteristics of an arrangement for which an entity would be required to provide the information proposed in this Exposure Draft. Paragraph 44G also sets out examples of the different forms of such arrangements that would be within the scope of the Board's proposals.

Paragraphs BC5–BC11 of the Basis for Conclusions explain the Board's rationale for this proposal.

**Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you suggest instead and why.**

Yes, our members agree that the proposal provide an accurate characterisation of reverse factoring arrangements and appropriate examples of different forms of such arrangements. From an accounting perspective, our members recognise the benefit of providing a principles-based approach as opposed to having a stringent definition as this will ensure that companies provide complete information about these arrangements.

## Question 2 – Disclosure objective and disclosure requirements

Paragraph 44F of the [Draft] Amendments to IAS 7 would require an entity to disclose information in the notes about supplier finance arrangements that enables users of financial statements to assess the effects of those arrangements on an entity's liabilities and cash flows.
To meet that objective, paragraph 44H of the [Draft] Amendments to IAS 7 proposes to require an entity to disclose:
(a) the terms and conditions of each arrangement;
(b) for each arrangement, as at the beginning and end of the reporting period:
(i) the carrying amount of financial liabilities recognised in the entity's statement of financial position that are part of the arrangement and the line item(s) in which those financial liabilities are presented;
(ii) the carrying amount of financial liabilities disclosed under (i) for which suppliers have already received payment from the finance providers; and
(iii) the range of payment due dates of financial liabilities disclosed under (i);
(c) as at the beginning and end of the reporting period, the range of payment due dates of trade payables that are not part of a supplier finance arrangement.

Paragraph 44I would permit an entity to aggregate this information for different arrangements only when the terms and conditions of the arrangements are similar.
Paragraphs BC12–BC15 and BC17–BC20 of the Basis for Conclusions explain the Board's rationale for this proposal.

**Do you agree with this proposal? Why or why not? If you agree with only parts of the proposal, please specify what you agree and disagree with. If you disagree with the proposal (or parts of it), please explain what you suggest instead and why**

The IA strongly supports the disclosure objective set out in in paragraph 44F - "*An entity shall disclose information about its supplier finance arrangements (as described in paragraph 44G) that enables users of financial statements to assess the effects of those arrangements on the entity's liabilities and cash flows*." The proposed disclosure requirements will aid in curtailing current issues of investors potentially misallocating capital when such arrangements are not disclosed. Requiring companies to disclose reverse factoring arrangements would improve transparency, allowing investors to more accurately assess an issuer's exposure to liquidity risks and to take into account the impact of these arrangements on the issuer's cash-flow and debt profile. Public provision of this information will improve the overall integrity of the market.

The IA and members widely support all proposed disclosure requirements set out in paragraph 44H, but suggests an average position of reverse factoring arrangements over the reporting period is disclosed. Our members have raised concerns over the potential for companies to 'window dress' reverse factoring arrangements. It is possible that a company could cancel arrangements they do not wish to disclose, before the end of the reporting period, and then reinstate them after the reporting period, thereby concealing the true impact of these arrangements on the amount and terms of the issuer's debt and their cash flows. An average position will give investors a clearer and more accurate view on the use of these arrangements during the year. We do not believe that average position disclosures would be a disproportionately onerous disclosure for entities to produce, especially when considering the additional value it would provide to the financial statements and the users of those statements. Any additional disclosures to prevent the potential of 'window dressing' are welcomed.

## Question 3 – Examples added to disclosure requirements

Paragraph 44B of the [Draft] Amendments to IAS 7 and paragraphs B11F and IG18 of the [Draft] Amendments to IFRS 7 propose to add supplier finance arrangements as an example within the requirements to disclose information about changes in liabilities arising from financing activities and about an entity's exposure to liquidity risk, respectively.

**Paragraphs BC16 and BC21–BC22 of the Basis for Conclusions explain the Board's rationale for this proposal.**
**Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you suggest instead and why.**

The IA strongly supports the proposal to add reverse factoring arrangements as an example to highlight the importance of providing information about non-cash changes in liabilities. The proposal provides a resolution for the existing information asymmetry which is widely supported by our members. Investors are currently at risk if finance providers suddenly remove such financing arrangements as there is a lack of insight into the terms of these arrangements. Additional transparency, whereby companies provide a narrative on the use of arrangements and disclose potential exposures to liquidity risk is therefore welcomed.