Are trade payables still trade payables?

By John Kent and Kate Hamilton

The question ‘are trade payables still trade payables?’ may be initially perceived as a simple question. However, over the past ten years, developments in Supplier Finance arrangements that bring banks into the equation has made this an increasingly difficult judgment for certain Buyers.

In this article, Deloitte provides an overview on the proposed guidance issued by the International Accounting Standards Board (IASB) that may answer this trade payables question and discusses how this guidance also requires Buyers to better explain their use of Supplier Finance arrangements.

What is the current situation and issue?

An example that illustrates the current situation for Buyers is: hypothetically, if a corporation, “Corporate Z,” buys widgets from a supplier, “Supplier A” on normal credit terms of 30 days credit, it books the unsettled invoices as ‘Trade Payables.’ In this scenario, Corporate Z would prefer 60 days credit, but that timing would be too long for Supplier A.

Supplier Financing—or Reverse Factoring—would be the potential solution in this example. Corporate Z would team up with a bank, “Bank C” whereby Supplier A’s invoices are transferred to the bank who settles them after 30 days as normal and, in turn, the bank claims the cash back from Corporate Z after 60 days. After a few small fees are negotiated, Corporate Z has managed its working capital cash flows, Supplier A gets paid as normal, and the Bank generates fees commensurate with 30-day lending—everyone emerges a winner.

However, Corporate Z has an IFRS reporting conundrum. The counterparty for the payables is now the bank, not Supplier A. So, this poses the question: Are the unsettled invoices now a form of finance debt, e.g., Bank Loans Payable, rather than Trade Payables in Corporate Z's balance sheet? To a Buyer, Bank Loans Payable may have knock on consequences for a host of reasons—covenants, gearing, balance sheet optics, etc. Furthermore, another question that must be addressed is understanding where do the settlement cash flows get presented in the cash flow statement—as operating cash flows or financing cash flows?

Extending from 30 days to 60 days may not seem controversial at the onset, however, some arrangements may stretch settlement terms even longer. At what point is it no longer appropriate to present these arrangements as Trade Payables and reclassify as Bank Loans? What are the relevant pointers? What are 'normal credit terms' if that IFRS term is a dividing line for presentation purposes? And, what happens when these supplier finance programs scale as larger, more organized initiatives that are backed by specialist finance houses intent on extending the timing of cash flows to the limits as far as they can, while continuing to argue for a Trade Payable presentation for their clients? Given all payables are a form of debt, when does the presentation of such arrangements potentially mischaracterize the entity's financial position and so create a risk for the entity? Following some high-profile corporate collapses, some have suggested that certain undisclosed Supplier Finance / Reverse Factoring arrangements may have been a contributing factor in flattering balance sheet appearance and masking reported debt, liquidity risks, and reliance on third party funding providers.

Firstly, the IASB's IFRS Interpretations Committee took a look at the issue

How do preparers identify the appropriate dividing line between Trade Payables and Bank Debt for these arrangements? Until now, there has been limited guidance to address this question.

To help fill the void, in December 2020 the IASB's IFRS Interpretations Committee published an agenda decision in response to a question from a credit rating agency. The agency had enquired how a reporting entity is required to present liabilities to pay for goods or services received when the related invoices are part of a Reverse Factoring arrangement, and what information about Reverse Factoring arrangements is required to be disclosed in its financial statements.

In its response to the submission, the Committee noted that, although IFRS does not make any *explicit* reference to Supplier Finance arrangements, IFRS does contain requirements such as what is a trade payable as well as general disclosure requirements designed to meet the information needs of users that can be applied to these types of arrangements. This means that, to the extent that Reverse Factoring arrangements are relevant to an understanding of financial statements, the current requirements of IFRSs would call for disclosure of accounting policies applied and separate presentation of the related liabilities.

Secondly, the IASB proposed changes

However, the IASB was subsequently informed that without *targeted* amendments there would be ongoing concern that users would not obtain consistent and comparable information across reporting entities. Consequently, in November 2021, the Board issued an Exposure Draft proposing new specific disclosures for these arrangements by amending IAS 7 *Cash Flow Statements* and IFRS 7 *Financial Instruments: Disclosures*.

So what is proposed to change?

The proposed amendments provide more transparency around Supplier Finance arrangements. Rather than relying on more general disclosures requirements on financial statement presentation and liquidity risk currently in IFRS that are open to interpretation, the proposed amendments are far more on point: if the buyer uses these arrangements, then disclose them specifically, including key terms and quantification of amounts in the balance sheet.

It is likely that, at a stroke, these amendments will reduce the diverging approaches to disclosure in this area. The amendments do not change the presentation principles of IFRS—judgment is still needed to decide whether payables subject to these arrangements are classed as Trade payables or Bank Loans. However, Buyers are now more likely to have to furnish far more detailed information on such arrangements which may shine a greater light on the use of such arrangements and the accounting policies and judgments applied.

The IASB's Exposure Draft ED/2021/10 that contain the proposals is available here. Comments to be received by 28 March 2022.

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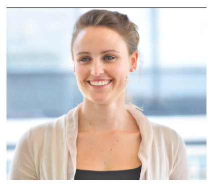

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