KPMG

Working Capital Managment

Reporting Update

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Highlights

- Supplier financing
- Inventory financing
- Receivables financing
- Insurance over trade receivables

Many organisations are actively managing their working capital. This includes entering into supplier and inventory financing arrangements, monetising their trade receivables balances and protecting the value of trade receivables by insuring against loss in the event of default.

There are flow-on financial reporting impacts when organisations engage in these types of activities, including the presentation on the balance sheet, income statement and cash flow statement and whether there are sufficient disclosures about the arrangements to ensure that users of financial statements understand the extent and nature of such arrangements.

This Reporting Update considers these financial reporting impacts and provides some action points when considering whether the impacts of working capital management activities are appropriately reflected in the financial report.

Supplier financing

Supplier financing or reverse factoring is used by some organisations to manage their working capital. Under these arrangements an organisation enters into an agreement with a financier where the financier agrees to pay the organisation's suppliers and the organisation will pay the financier at a later date. It also streamlines the organisation's accounts payable process as the organisation typically only has to make a single monthly payment to the financier rather than managing the payment of all the individual supplier's invoices.

Nature of Liability on balance sheet

Nature of supplier financing is judgemental

One of key accounting issues surrounding these arrangements is how this liability should be presented on the balance sheet. AASB 101 *Presentation of financial statements* does not prescribe the sub captions on the balance sheet. In addition, there is no definition of debt or trade payables in accounting standards. There is only a reference to trade payables in AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* which states that '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'.

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Hence the presentation of the amounts on the face of the balance sheet is an area of judgement.

Does the liability form part of working capital?

Organisations present liabilities that are part of reverse factoring arrangements:

- as trade and other payables only when those liabilities have similar nature and function to trade payables – for example when those liabilities are part of the working capital used in the entity's normal operating cycle
- separately when the size, nature or function makes separate presentation relevant to an understanding of the organisation's financial position.

Presentation in the cash flows statement

The presentation in the cash flows statement depends on the structure of the arrangement. If the payment from the financier to supplier does not flow through the organisation, which is the way these arrangements are typically structured, then the organisation will only show a single cash outflow when it pays the financier in the cash flow statement.

The classification of this cash flow as either operating or financing depends on how the liability is classified on the balance sheet. If the liability is classified as part of trade and other payables, the cash flow forms part of cash flows from operating activities. However, if the liability is not considered part of working capital and instead represents borrowings of the organisation, the cash flows will form part of financing activities.

Where the initial payment to the supplier does not flow through the organisation, the organisation should also consider whether disclosures around non-cash transactions for investing and financing activities in AASB 107 *Cash flow statements* are also applicable. An example disclosure may include:

> *The payments to the bank are included within operating cash flows because they continue to be part of the normal operating cycle of the Group and their principal nature remains operating – i.e. payments for the purchase of goods and service. The payments to a supplier by the bank are considered non-cash transactions and amount to $524 thousand (2020: $352 thousand)*

Financial risk management disclosures

Given there is judgement about how the liability and the cash flows subject to these arrangements should be presented on the balance sheet and Statement of Cash Flows, organisations should consider disclosing these judgements in the financial statements.

In addition, AASB 7 *Financial Instruments: Disclosures* requires organisations to include information that enable users of financial statements to evaluate the nature and extent of risks arising from financial instruments. Payables, like borrowings, are financial liabilities captured by AASB 7. Therefore, supplier financing arrangements are likely to form part of the entity's management of liquidity risk and therefore they should be included in both the qualitative and quantitative liquidity risk disclosures.

This will include details of the nature of these arrangements and the extent to which the organisation is currently using them. The required disclosures will depend on an organisation's specific facts and circumstances. An example disclosure may include:

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The Group participates in a supply chain finance programme (SCF) under which its suppliers may elect to receive early payment of their invoice from a bank. Under the arrangement, a bank agrees to pay amounts to a participating supplier in respect of invoices owed by the Group and receives settlement from the Group at a later date.

The Group has not derecognised the original liabilities to which the arrangement applies because neither a legal release was obtained, nor the original liability was substantially modified on entering into the arrangement. From the Group's perspective, the arrangement does not significantly extend payment terms beyond the normal terms agreed with other suppliers that are not participating. The Group does not incur any additional interest towards the bank on the amounts due to the suppliers. The Group therefore discloses the amounts factored by suppliers within trade payables because the nature and function of the financial liability remain the same as those of other trade payables but discloses disaggregated amounts in the notes. All payables under the SCF are classified as current as at 31 December 2021 and 2020.

Impacts on debt covenants

Are supplier financing arrangements considered debt for debt covenant calculations?

Some organisations may also have to consider the impact of supplier financing arrangements on their debt covenants. Such arrangements may be classified as a debt instrument under the covenant conditions and hence increase the risk of a covenant breach. Further complexities arise when the covenants rely on 'trade payables' or 'debt' as defined by the accounting standards, as accounting standards do not define these terms.

In some instances, legal opinion may be required to confirm whether an arrangement falls within the scope of the debt covenant conditions.

Other regulatory requirements

Under the Payment Times Reporting Act, large businesses and government enterprises are required to report to the new Payment Times Reporting Regulator their payment practices to their small business suppliers, including whether supply chain financing is being offered to suppliers.

Actions

Organisations with supplier financing arrangements should consider whether:

- the nature of the liability on the balance sheet and the cash flows in the cash flows statement are appropriately classified
- the disclosures in the notes are appropriate and provide users with sufficient information to understand the risks associated with such an arrangement
- confirmation is required from their debt providers as to the impact of these types of facilities on their debt covenant calculations
- they have complied with the reporting under the new Payment Times Reporting Act.

Inventory financing

Inventory financing are typically short-term loans used by organisations for purchasing stock or materials that are for sale or used in the production process. They are commonly used where there is a time lag between the purchase and use in the production process or sale. The financier pays the supplier for the products upfront and the organisation repays the financier at a later date. To initiate these arrangements, some organisations may involve the financier during the purchase process with the supplier.

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Inventory financing – who controls the goods?

Careful analysis is required to determine whether the financier or the organisation controls the product initially. If the organisation controls the product then it is recognised as inventory with a corresponding liability to the financier. Alternatively, if the financier controls the product, then both the product and liability are 'off balance sheet' in the financial statements of the organisation. In this scenario, the organisation will likely only control and recognise the inventory and liability at a later date, closer to use or sale.

Considerations of who controls the product may include:

- Who has the relationship with the supplier, who decides which supplier to use, type of goods and the quantity to purchase? If it is the organisation, this may indicate the organisation controls the product.
- Who is exposed to inventory obsolescence? Does the organisation have a minimum purchase agreement with the financier? For example, if the financier purchases 100 units from the supplier, and the organisation must purchase 100 units from the financier, this may be an indicator the organisation controls the product.
- Can the financier redirect the product to another entity and still meet its obligations to supply to the organisation? In our view, any ability to redirect needs to be substantive. For example, even though legally it could redirect or sell to another entity, if this results in the financier being unable to meet its obligations to supply to the organisation, the right to redirect or sell is not likely to be substantive. This may indicate that the organisation controls the product.
- How is the pricing structured? For example, when the financier 'sells' to the organisation, is it at a market price or is it priced such that the financier receives some fee akin to interest on the original purchase price. The latter may indicate the organisation controls the product.
- What are the specific arrangements around storage, access and physical control of the product whilst it is 'owned' by the financier?

The above considerations are indicators only and are not exhaustive. To assess whether the organisation or the financier controls the product requires careful consideration of the facts and circumstances, including the nature of the specified product and the terms and conditions of the arrangement.

Inventory financing – has there been a sale in a sale and buy-back?

In other scenarios, organisations may enter into arrangements with the financier where they agree to 'sell' their inventory and to 'buy' back at a later date. In such situations, the organisation will need to consider the repurchase guidance in AASB 15 *Revenue from Contracts with Customers* and whether the organisation has transferred control of the product to the financier.

Liability classification on balance sheet

When the arrangement is recognised on balance sheet as inventory with a corresponding liability, a key financial reporting question is whether this liability is current or non-current. This requires careful consideration of the terms and conditions around the obligation to pay the financier, for example, whether the requirement to repay is linked to the expected sale of the underlying inventory. If this liability is considered part of working capital used in the organisation's normal operating cycle, it may still need to be presented as current even if the repayment date is greater than 12 months from balance date.

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Disclosure of collateral

When the product is recognised as inventory with a corresponding liability, the inventory is likely to be pledged as collateral for that liability. AASB 102 *Inventories* requires the disclosure of the carrying amount of inventories pledged as security for a liability. This may be reflected in the inventories note as follows:

X. Inventories		
	2021	***2020***
Raw materials	*250*	*264*
Finished Goods	*145*	*149*
Total Inventories	***395***	***413***
Carrying amount of inventories pledged as security for liabilities	*97*	*82*

In addition, organisations should consider including information about such arrangements in the qualitative and quantitative disclosures on their management of liquidity risk.

Actions

Organisations with inventory financing arrangements should consider:

- whether the financier or the organisation has control of the product both initially, or upon implementation of a sale and buy-back transaction
- the disclosures about the arrangement in the financial statements.

Receivables financing

Some organisations factor their receivables portfolio, where they receive funding from a financier upfront, with the agreement to repay the amount when it is received from their customers. One of the key considerations is whether the receivables are derecognised or "sold" from an accounting perspective. If the transaction does not qualify for derecognition, the transaction is recognised as a funding arrangement, with a liability recognised for the amount received.

The analysis to determine when financial assets, including trade receivables, are derecognised is complex. The primary question is whether the organisation has transferred substantially all risks and rewards of the trade receivables to the financier. For short-term receivables, this means determining whether, as a result of the 'sale' to the financier, the organisation is either no longer exposed to a risk of loss from a customer failing to pay, or if it is still exposed, its exposure is reduced substantially.

Receivables factoring – have substantially all risks and rewards been transferred?

A common point of discussion is how to assess the credit risk inherent in portfolios of receivables that have a history of negligible losses. Organisations that have incurred only minimal or no defaults from their receivables portfolios are still required to make the assessment of whether they have transferred substantially all of the risks and rewards when it enters into such a transaction. In some cases, a quantitative analysis is required to make this assessment.

For example, an organisation transfers its portfolio of short-term receivables of 1,000 to a financier and receives 990 upfront. The organisation agrees to deliver the first 992 received from its customers to the financier and will retain any amounts collected in excess of the 992. The expected credit loss for the portfolio is 1 (0.1%), and the likely range of losses is between 0.5 to 1.5 with a 99.9% confidence interval. That is, the organisation expects to collect between 998.5 and 999.5 for these receivables. In this case, it is likely that the organisation has not transferred substantially all of the risks, as it has a continued exposure to the performance of the portfolio given any expected loss will be borne by the organisation. A more complex quantitative analysis may be required in

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circumstances where the organisation transfers individual invoices, rather than portfolio of receivables.

Where such arrangements do not meet the derecognition criteria, the receivables remain on balance sheet and a financial liability is recognised for the funds advanced from the financier.

Liability classification on balance sheet

Where the arrangement does not result in a sale or derecognition of the receivables, the organisation recognises a financial liability for the obligation to repay the funds received. A key question is whether this liability is current or non-current. This requires careful consideration of the terms and conditions around the obligation to pay the financier including whether it is linked to the expected timing of receipt from the customer. For example, an organisation sells eligible receivables with a credit terms of 30 days, and in exchange it receives monies upfront. It agrees to pass to the financier the monies when collected from its customers and where there is shortfall after day 30, it will make up the shortfall. In this case, the liability will be classified as current as the organisation has an obligation to deliver cash to the financier in 30 days. If this liability is considered part of working capital used in the organisation's normal operating cycle, it may still need to be presented as current even if the repayment date is greater than 12 months from balance date.

Disclosure of collateral

Where the factoring arrangement results in the recognition of a financial liability, the transferred receivables portfolio act as collateral for the associated debt. This arrangement falls within the disclosures for 'transferred assets that are not derecognised in their entirety' in AASB 7 *Financial Instruments: Disclosures*, which include:

Receivables factoring will trigger collateral disclosures

- A description of the collateral agreement including any restrictions over the receivable balances
- The carrying amount of the receivables and associated borrowings
- The risks and rewards associated with the receivables to which the organisation is still exposed.

An example disclosure may read as follows:

A. Transfer of trade receivables

The Group sold trade receivables to a bank for cash proceeds. These trade receivables have not been derecognised from the statement of financial position, because the Group retains substantially all the risks and rewards – primarily credit risk. The amount received on transfer has been recognised as a secured bank loan. The arrangement with the bank is such that the customers remit cash directly to the Group and the Group transfers the collected amounts to the bank.

The receivables are considered to be held within a held-to-collect business model consistent with the group's continuing recognition of the receivables.

The following information shows the carrying amount of trade receivables at the reporting date that have been transferred but have not been derecognised and the associated liabilities.

	2021	***2020***
Carrying amount of trade receivables transferred to bank	*600*	*1000*
Carrying amount of associated liabilities	*598*	*985*

Actions

Organisations with factoring arrangements should consider:

- whether the receivables are derecognised
- where a liability is recognised, the classification of the liability
- the disclosures about the arrangement in the financial statements.

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Managing credit losses - Insurance over trade receivables

Some organisations may also insure the collectability of their trade receivables. That is, the insurer compensates the organisation if its customers default and it suffers a loss. Given the current global economic environment, there is a risk that insurance over receivables may not be renewed when policies expire. This may present a significant business risk to some organisations, for example, where their margins are slim.

Impacts on ECL calculations

Insurance over receivables are generally not included in ECL calculations

Trade receivables insurance typically is not considered part of the underlying receivable and as such, the impact of the insurance is not reflected in an organisation's expected credit loss (ECL) calculation. The ECL calculation should reflect the expected cash flows from the receivables, excluding the impact of the insurance policy over these balances. A situation may arise where the loss event that creates a right for the organisation to claim under the insurance contract has not yet occurred, but an impairment loss has been recognised under AASB 9 as it is based on the expected future losses. We believe that in this instance, the organisation should recognise a compensation right when it recognises the related ECL, provided it is virtually certain that the compensation will be received if the credit loss is actually incurred. This may require careful consideration of the terms and conditions of the policy if they are close to expiry.

The recoverability under the insurance policy is recognised separately on the balance sheet, but the amounts may be able to be netted in the income statement.

Disclosure of credit enhancements

Disclosure of insurance over receivables as a credit enhancement

Insurance cover over trade receivables is a credit enhancement and as such is captured by the disclosure requirements for 'collateral and other credit enhancements' under AASB 7. Organisations are expected to disclose in their financial risk management note:

- a description of the insurance held during the year
- changes to the insurance coverage during the year
- the extent to which the insurance mitigates the credit risk of any receivables that are credit impaired at year end
- the amount recovered under the insurance policy during the year.

An example of these disclosures may include:

> ***B. Credit enhancements***
> *The group has credit insurance over their trade receivables as at 30 June 2021(no change from prior year). This insurance provides coverage on losses in excess of $50 thousand on any single debtor. During the year $nil (2021: $nil) was recovered under the insurance policy. As at year-end no (2020: NIL) trade receivables in excess of $50 thousand were credit impaired.*

Actions

Organisations with trade receivables insurance should:

- check that the credit insurance is not reflected in the ECL calculation
- assess whether the compensation rights should be recorded when a related ECL is recognised
- consider the impact on the credit enhancement disclosures in the financial statements
- where the policies are close to expiry, engage with their insurers to ensure ongoing coverage.

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In Summary

Organisations who actively manage their working capital should consider the financial reporting impacts including whether there are adequate disclosures for users to understand the impact on their business. Organisations with supplier financing arrangements also need to consider including details of such arrangements as part of their reporting obligations under the new Payment Times Reporting Act.

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