CHAPTER 1

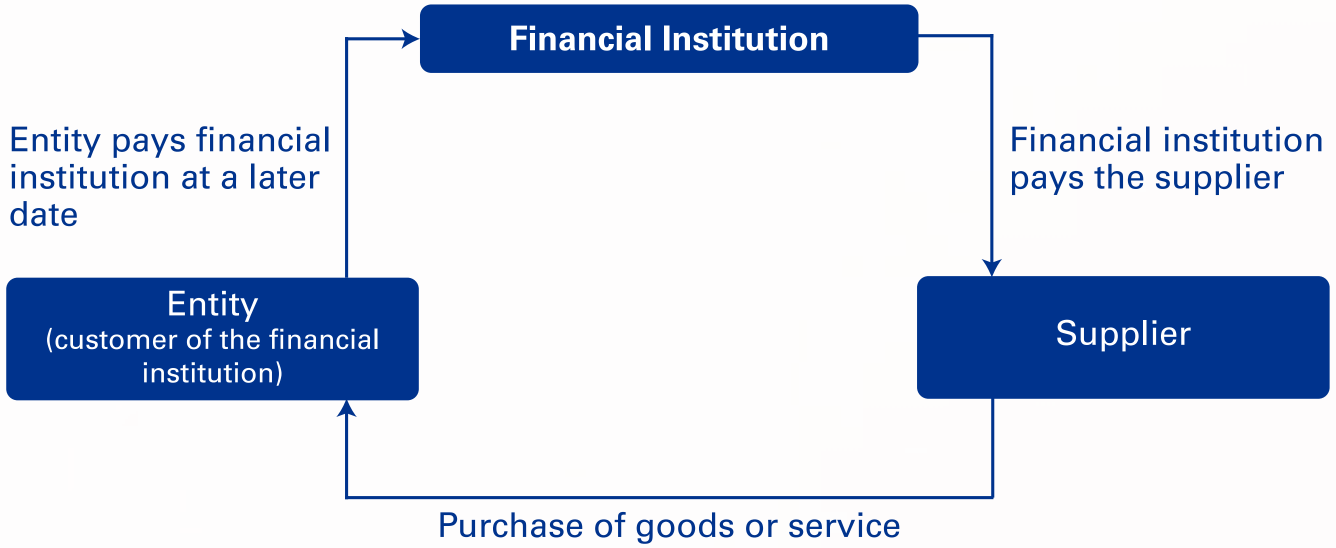
Reverse factoring arrangement – presentation in the financial statements

This article aims to:

- Provide key considerations for presentation of reverse factoring arrangement in the balance sheet, statement of cash flows and notes to the financial statements.

Introduction

Reverse factoring is a common form of supply chain financing involving three parties: an entity that purchases a good or service, a supplier providing those goods or services and a financial institution. The arrangement typically allows the supplier to be paid by the financial institution at a date earlier than the entity pays the financial institution.



(Source: KPMG in India analysis, 2023)

In a traditional factoring arrangement, a supplier of goods or services obtains cash from a bank or other financial institution (i.e. the factor) against receivables due from its customers.

In contrast, reverse factoring is initiated by the customer of the financial institution (in this case, the purchase of goods or services) and the financial institution (factor).

A reverse factoring arrangement may provide liquidity to the entity (i.e. customer of the financial institution) if it allows deferral of payment to the factor beyond the original maturity of the supplier's invoice or if the arrangement enables the entity to negotiate extended payment terms with its supplier. Depending on the terms of the arrangement, and similar to traditional factoring, the reverse factoring arrangement may also provide to the supplier:

- Liquidity by enabling it to receive cash before the invoice due date and
- Access to funding at a lower interest rate based on the customer's credit rating.

Similarly, the reverse factoring arrangement may allow the customer to take advantage of an early payment discount offered by the supplier. The reverse factoring arrangement may also allow the supplier and the customer to make administrative savings through more streamlined collection and payment procedures.

The terms of reverse factoring arrangements vary depending on the agreement between the entity, its suppliers and the financial institution. Therefore, depending upon the terms of reverse factoring arrangements, presentation in the balance sheet and statement of cash flows may also change. Further, due to the impact on the financial statements, it is also important to appropriately provide disclosures in relation to reverse factoring arrangement in the financial statements.

There is no specific guidance in the Ind AS/IFRS on presentation of reverse factoring arrangements in the financial statements. In this regard, the IFRS Interpretations Committee[1] (IFRIC) discussed the presentation of liabilities that are part of reverse factoring arrangements in the balance sheet and presentation in the statement of cash flows under IFRS. The Committee published its agenda decision in December 2020 that provided guidance/ explanatory information on presentation of liabilities that are part of a reverse factoring arrangement in the balance sheet, presentation in the statement of cash flows and disclosures in notes to the financial statements.

A common scenario of a reverse factoring arrangement

Company ABC is in the business of manufacturing and selling product X. The company enters into a reverse factoring arrangement with a bank as per which:

- Company will upload the supplier invoice on due date on bank's platform;
- The bank will give quote for the invoice financing for 60/90/180 days at interest rate specified in offer;
- On acceptance by the company, the amount will be paid to supplier on due date by the bank on behalf of company; and
- Company would pay to the bank at a later date (60/90/180 days) along with the interest.

1. The IFRS Interpretations Committee (Interpretations Committee) is the interpretative body of the International Accounting Standards Board (IASB). The Interpretations Committee works with the IASB in supporting the consistent application of IFRS Accounting Standards. The Interpretations Committee responds to questions about the application of the Accounting Standards and does other work at the request of the IASB. Agenda decisions often include explanatory materials to help entities in applying IFRS Standards.

Presentation in the balance sheet

Under Indian Accounting Standards (Ind AS), Ind *AS 1, Presentation of Financial Statements* specifies how an entity is required to present its liabilities in the balance sheet.

Further, the Schedule III to the Companies Act, 2013 lays down the framework for preparation of financial statements which is sub-divided into three divisions. Division-II to the Schedule III is applicable for the Companies which prepare their financial statements in accordance with Ind AS.

Ind AS 1 and Schedule III to the Companies Act, 2013 (Division-II) requires separate presentation of trade payables and borrowings on the balance sheet. Further, Ind AS 1 state that an entity shall present additional line items, headings and subtotals in the balance sheet when such presentation is relevant to an understanding of the entity's financial position.

Hence, under Ind AS, it is important to determine whether to present liabilities that are part of a reverse factoring arrangement:

- Within trade payables;
- Within borrowings; or
- As a separate line item in balance sheet.

Consistent with IFRIC agenda decision, an entity presents such liabilities as part of 'trade payables' when those liabilities have a similar nature and function to trade payables, i.e. when those liabilities are part of the working capital used in the entity's normal operating cycle and are in respect of the amounts due on account of goods purchased or services received in the normal course of business.

An important aspect to be noted in this respect is that reverse factoring arrangement, in some cases, may result in the derecognition of the original trade payable and the recognition of a new financial liability and in other cases, there may not be de-recognition - would depend on whether there is legal release or whether there is substantial modification. However, consistent with IFRIC agenda decision discussed above, regardless of whether the original trade payable is derecognised, presentation of amounts related to reverse factoring arrangements needs to be done as per Ind AS 1, i.e. new financial liability owed to financial institution could still be presented as 'trade payables'.

Following are examples of features that may indicate that the nature or function of the amounts due is sufficiently different from a trade payable:

- The principal business purpose of the reverse factoring arrangement is to provide funding to the customer, rather than to provide funding to the supplier or to facilitate efficient payment processing
- The factor is a bank or similar financial institution and
- The arrangement:
  - Significantly extends payment terms beyond the normal terms agreed with other suppliers
  - Adds a requirement for the customer to pay interest or to pay interest at a higher rate
  - Requires additional collateral or a guarantee or
  - Changes the terms defining default and cancellation

Presentation in the statement of cash flows

Consistent with IFRIC agenda decision, in relation to presentation in the statement of cash flows, judgement needs to be first applied to assess whether a single cash outflow or multiple cash flows occur for the entity. This assessment is based on the specific facts and circumstances and the entity may consider whether the factor in substance acts on behalf of the entity in the reverse factoring arrangement.

Single cash outflow

- Payment to the supplier by the factor is a non-cash transaction that requires disclosure as per of Ind AS 7, *Statement of Cash Flows*.
- A single cash outflow for cash payments made to the factor is presented as operating or financing cash outflow. An entity applies judgement in determining whether to classify payments made to the factor as an operating or financing cash outflow, giving consideration to the primary principle that cash flows are classified according to the nature of the activity to which they relate, taking into account the specific facts and circumstances.

  For example, an entity needs to consider if the principal business purpose of the reverse factoring arrangement is to provide funding to the supplier or to facilitate efficient payment processing, and whether the reverse factoring arrangement significantly extends payment terms beyond the normal terms agreed with other suppliers.

Multiple cash flows

Gross cash flows are presented - i.e. financing cash inflows and operating cash outflows when the factor makes a payment to the supplier in respect of the purchase of goods or services made by the entity, together with a financing cash outflow for settlement of amounts due to the factor.

Key disclosures in notes to the financial statements

Given the impact on the financial statements, it is important to appropriately provide disclosures in relation to reverse factoring arrangement in the financial statements. Some of the key disclosures would include:

- Disclosure of significant accounting policies as per Ind AS 1
- Disclosure of significant judgements made in the process of applying the accounting policies and that have the most significant effect on the amounts recognised in the financial statements as per Ind AS 1
- Qualitative disclosures about the entity's exposure to liquidity risk as per Ind AS 107, *Financial Instruments: Disclosures*
- Quantitative information relating to liquidity risk, including concentrations of it as per Ind AS 107
- Where cash flows for related liabilities are classified as financing activities, disclosures that enable users to evaluate changes in liabilities arising from financing activities as per Ind AS 7.

Future developments

In November 2021, IASB published an Exposure Draft *Supplier Finance Arrangements - Proposed amendments to IAS 7 and IFRS 7* in response to users' calls for additional information about such arrangements in financial statements. The proposals did not address the classification or presentation of the related liabilities and cash flows. Rather, the proposals complement the IFRS Interpretations Committee's agenda decision Supply Chain Financing Arrangements - Reverse Factoring published in December 2020.

The proposals require entities to disclose information about their supplier finance arrangements that enables users of financial statements to assess the effects of those arrangements on the entity's liabilities and cash flows. The proposals would introduce a new disclosure objective in IAS 7 and specific disclosure requirements in IAS 7 and IFRS 7, including the following:

- The terms and conditions of each supplier finance arrangement (including, for example, extended payment terms and security or guarantees provided)
- For each supplier finance arrangement, at the beginning and the end of the reporting period:
  a. 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
  b. The carrying amount of financial liabilities that are part of the arrangement for which suppliers have already received payment from the finance providers and
  c. The range of payment due dates (e.g. 30 to 40 days after the invoice date) of financial liabilities that are part of the arrangement
- At the beginning and the end of the reporting period, the range of payment due dates of trade payables that are not part of a supplier finance arrangement and
- Additional information about supplier finance arrangements necessary to meet the disclosure objective.

The amendments are expected to be issued in May 2023 and the IASB tentatively decided to require an entity to apply the amendments for annual reporting periods beginning on or after 1 January 2024.

Key points for consideration

Each reverse factoring arrangement must be assessed separately, taking into account the contractual terms and conditions. Entities need to carefully consider the principal business purpose of the reverse factoring arrangement, other terms and conditions of the arrangement, and apply judgement in determining the presentation in the balance sheet and statement of cash flows.

Entities should also carefully consider the disclosures that will be necessary to explain the nature of the reverse factoring arrangement, impact of the arrangement and the judgements made.

Source: KPMG IFRG Limited's publication Insights into IFRS, 19th edition, October 2022.