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IFRS Interpretations Committee
IFRS Foundation
Columbus Building
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By Electronic Mail: ifric@ifrs.org

Dear Members of the IFRS Interpretations Committee,

CLASSIFICATION AND DISCLOSURE OF LIABILITIES AND LIQUIDITY RISKS ARISING FROM SUPPLY CHAIN FINANCING ARRANGEMENTS

Moody's Investors Service (MIS) appreciates the opportunity to provide the International Financial Reporting Standards Interpretations Committee (the Interpretations Committee) with our observations on current practices in the classification and disclosure of liabilities and liquidity risks arising from supply chain financing (SCF) arrangements such as reverse factoring (RF). In our experience, the use of SCF arrangements, including RF, is widespread, but disclosure of the practice is not. In fact, as highlighted in recent MIS research,[1] fewer than 5% of the entities rated by MIS are actually disclosing usage together with the impact on their financial statements and risk profile.[2] This raises three concerns:

- **First, without adequate disclosure it is difficult for users of financial statements to compare companies using SCF with those that do not.** SCF itself takes many forms, and the consequences of RF may be different to other tools such as dynamic discounting. Disclosure of the nature of these liabilities is important to ensure all users of financial statements can transparently and consistently assess the nature of the company's aggregate debt-like liabilities.

- **Second, SCF arrangements obscure the nature of debt-like liabilities.** The purpose of SCF products, including RF, is deliberately to distort the natural working capital equilibrium between supplier and customer because it enables earlier payment to the supplier and later payment by the customer. The funding gap is bridged by a bank or

1 "Non-financial companies – Global: Reverse factoring is increasingly popular but can weaken liquidity at a time of stress," Moody's Investors Service,19 September 2019.

2 "*SCF Barometer 2018/2019*," PwC & Supply Chain Finance Community.

other funding provider. We are aware that some RF-providing banks will add together RF facilities with conventional debt facilities to calculate aggregate corporate exposure limits. Without consistent disclosure, stakeholders such as credit rating agencies cannot effectively evaluate aggregate leverage, and bondholders could potentially be frustrated in their ability to set and manage debt covenants effectively and consistently.

- **Third, default risk is obfuscated without adequate disclosure**. The lack of disclosure blurs the important distinction between operating and financing cashflows, and the risk of RF facilities falling away can materially increase default risk.

MIS requests that the Interpretations Committee consider providing guidance on:

1. **Disclosure** – the appropriate disclosure in the financial statements of a company when SCF arrangements are used; and

2. **Classification** – whether the process of overlaying an irrevocable payment undertaking over a simple trade invoice has the effect of transforming that invoice into a different obligation that should be disclosed separately from trade payables.

In the attached Annexes, we address these concerns in further detail (Annex I) and provide reasons for the Interpretations Committee to address the issue (Annex II).

We trust that the information provided in our letter is clear but please do not hesitate to contact us should you wish to discuss the submission or any aspect of it in further detail.

Yours faithfully,

/S/ **Philip Robinson**

Philip Robinson
Vice President – Senior Credit Officer
Corporate Finance

ANNEX I

I. Background

For every sector and company there is a natural equilibrium to working capital, though that equilibrium is not the same for every sector or company. It can fluctuate as a function of financial policy, credit quality and other factors. However, many forms of SCF distort the natural working capital equilibrium by introducing a gap between the point at which payment is made to the supplier versus the later point at which payment is made by the customer. This gap is bridged by financing, and such financing should be accurately disclosed so that it is transparent to all users of a company's financial statements.

There are multiple perspectives from which such improved disclosure is required:

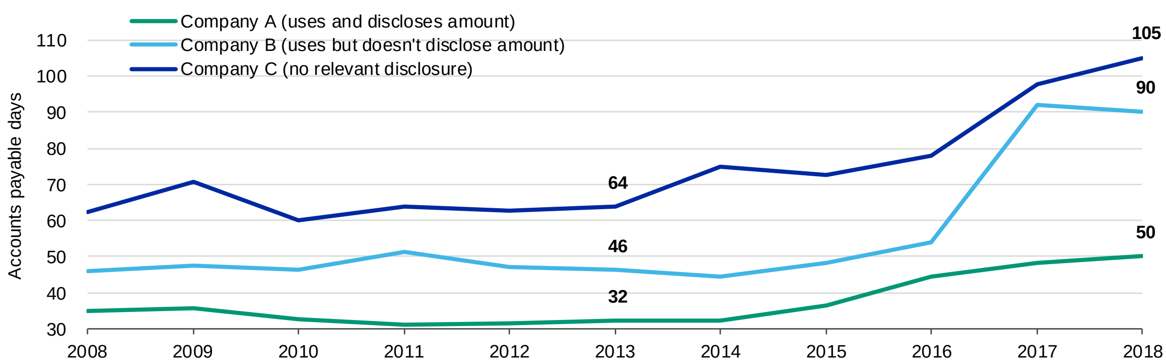
- **Leverage, coverage and covenants.** Many stakeholders use company financial statements to assess debt leverage or coverage levels. Different stakeholders may choose to take a wider or narrower definition of leverage, including or excluding elements such as lease financing alongside pure financial debt obligations. Different stakeholders may validly prefer different definitions to suit their varying requirements and comprehensive disclosure by the company would allow them to make an informed and accurate assessment. At present there is a risk that debt leverage and coverage covenants designed to measure and limit aggregate indebtedness may be frustrated by the lack of disclosure and potential omission of SCF liabilities.

- **Different types of SCF**. SCF is an umbrella label for a range of financing techniques, including RF and dynamic discounting. Improved disclosure about the use of different SCF tools would allow stakeholders to assess their differentiated impacts and risks, and whether the product is being used to extend payment terms beyond those that the supplier would accept in the absence of the facility.

- **Asymmetric disclosure**. At present if SCF usage and obligations are not disclosed, it appears that banks and other funding providers who provide SCF facilities, while at the same time participating in a company's core financing facilities, are better sighted on the company's aggregate funding requirements than other debt creditors such as bondholders who may primarily rely on reported information. Such a situation may favour SCF providers and allow such banks quickly to reduce exposure to the company if stress starts to crystallise, while other creditors may be disadvantaged. That asymmetric disclosure creates scope for unexpectedly asymmetrical losses for bondholders. While it may economically favour the bank in the short term, there is scope for broader reputational damage to the bank as well to the extent they knowingly leveraged asymmetrical information to their advantage. Both these issues could be mitigated through comprehensive disclosure in advance.

- **Impact of irrevocable payment undertakings (IPUs)**. We are aware that in some cases, before advancing early payment to a supplier, SCF providers may require that the customer provides an IPU in respect of the underlying invoice. By design that transforms a trade payable obligation – which might normally be disputed on the grounds of non-delivery or quality of goods and services provided, and has no absolute specific payment date – into a more certain and readily 'monetisable' asset whereby the right to challenge is waived and payment is undertaken to be made at a specific date. The benefits to the SCF provider are clear in that payment by the customer is now more certain than for a normal trade payable. We seek clarity on whether the process of overlaying an IPU on top of a simple trade invoice has the effect of transforming that invoice into a different obligation that should be disclosed separately from trade payables.

- **Consistency**. Specifically, we do not assert that SCF is 'a bad product' or that companies that use it should in some way be penalised. However, in rank ordering the credit quality of around 5,500 rated non-financial corporates, it is a challenge if disclosure is inconsistent. Consistent and transparent disclosure would aid our objective to accurately rank companies based on their credit quality. The chart below illustrates the evolution in the accounts payable days metric over the last three years for three companies in EMEA. The metrics all show a similar pattern, i.e. a multi-year trend at a consistent level followed by a marked increase, especially in the last two to three years. Company A discloses use of RF and the actual amount; Company B discloses use of SCF but not the amount; Company C does not explain the increase in its financial statements. To reiterate, we make no criticism of Company A or Company B for using SCF, nor of Company C for not disclosing (and without disclosure, we cannot reliably tell whether the rise is attributable to SCF or some other reason).



In our September 2019 report "Non-financial companies – Global: Reverse factoring is increasingly popular but can weaken liquidity at a time of stress", we highlighted the disclosure by Wm Morrison Supermarkets plc, disclosing usage, facility size and, that its liquidity policy was calibrated to ensure liquidity headroom even based on the conservative planning assumption that SCF facilities were no longer available. It is an example that we found helpful in addressing some of the transparency concerns highlighted in this letter and assisted with our understanding of the company's credit profile.

ANNEX II

Reasons for the Interpretations Committee to Address the MIS Request

a. Is the issue widespread and has, or is expected to have, a material effect on those affected?

Yes. According to a recent report from the Supply Chain Finance Community and PwC,[3] more than 50% of companies are using SCF, however, fewer than 5% of the entities rated by MIS are disclosing usage together with the impact on their financial statements and risk profile (as highlighted in our September 2019 report "Non-financial companies – Global: Reverse factoring is increasingly popular but can weaken liquidity at a time of stress").

SCF facilities have the potential to have very material impacts on companies, where:

- trade terms have been extended but the liabilities remain classified as trade payables without further disclosure; or
- facilities are withdrawn in times of stress, creating further pressure on liquidity.

b. Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

Yes. At present it is challenging to compare companies that do not disclose the existence and usage of SCF facilities. Liabilities may be included on the balance sheet under the caption 'trade payables' without identification of the fact that these may be due to a single obligor under a SCF facility, and the terms of these payables may be different to those the supplier would accept in the absence of such a facility. In cases where the company has chosen to identify these liabilities as a separate line item, there can be inconsistencies in the cash flow statement, where payment of the obligation is treated as a financing cash outflow rather than operating. However, if the existence of the facility is known, and the disclosure is clear, we are able to factor this into our analysis.

SCF is a broad label which encompasses many different underlying tools. For example, the consequences of RF and dynamic discounting may be very different, but without sufficient disclosure these differences cannot be assessed.

c. Can the issue be resolved efficiently within the confines of IFRS and the Conceptual Framework for Financial Reporting?

Yes. We believe guidance already exists in International Financial Reporting Standards (IFRS), in paragraphs 3.3.1 and 3.3.2 of IFRS 9, paragraphs 58 and 122 of International Accounting Standard (IAS) 1, and paragraphs 14, 17 and 43 of IAS 7.

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[3] "*SCF Barometer 2018/2019*," PwC & Supply Chain Finance Community.

d. Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process?

Yes. It is only concerned with the interpretation of the paragraphs mentioned in c above.

e. Will the solution be developed by the Interpretations Committee be effective for a reasonable period of time?

Yes. We are not aware of any current or planned International Accounting Standards Board project on SCF.