

# IFRIC Update December 2020

IFRIC *Update* is a summary of the decisions reached by the IFRS Interpretations Committee (Committee) in its public meetings.

The Committee met on [1–2 December 2020](#), and discussed:

## Committee’s tentative agenda decisions

- [Classification of Debt with Covenants as Current or Non-current \(IAS 1 \*Presentation of Financial Statements\*\)—Agenda Paper 2](#)
- [Attributing Benefit to Periods of Service \(IAS 19 \*Employee Benefits\*\)—Agenda Paper 3](#)
- [Configuration or Customisation Costs in a Cloud Computing Arrangement \(IAS 38 \*Intangible Assets\*\)—Agenda Paper 5](#)
- [Hedging Variability in Cash Flows due to Real Interest Rates \(IFRS 9 \*Financial Instruments\*\)—Agenda Paper 6](#)

## Committee’s agenda decisions

- [Supply Chain Financing Arrangements—Reverse Factoring—Agenda Paper 4](#)

## Other matters

- [Work in Progress—Agenda Paper 7](#)

## Related information

Next scheduled IFRS Interpretations Committee meeting:

2 February 2021

[Interpretations Committee open items](#)

For further information about IFRS Interpretations Committee activities including how to receive past IFRIC Updates follow the [Interpretations Committee group page](#).

## **Committee’s tentative agenda decisions**

The Committee discussed the following matters and tentatively decided not to add standard-setting projects to the work plan. The Committee will reconsider these tentative decisions, including the reasons for not adding standard-setting projects, at a future meeting. The Committee invites comments on the tentative agenda decisions. Interested parties may submit comments on the [open for comment](#) page by 15 February 2021. All comments will be on the public record and posted on our website unless a respondent requests confidentiality and we grant that request. We do not normally grant such requests unless they are supported by a good reason, for example, commercial confidence. The Committee will consider all comments received in writing by 15 February 2021; agenda papers analysing comments received will include analysis only of comments received by that date.

### **Classification of Debt with Covenants as Current or Non-current (IAS 1 Presentation of Financial Statements)—Agenda Paper 2**

In January 2020 the International Accounting Standards Board (Board) issued *Classification of Liabilities as Current or Non-current*, which amended IAS 1 *Presentation of Financial Statements* and clarified how to classify debt and other financial liabilities as current or non-current in particular circumstances (IAS 1 amendments). The amendments are effective for annual reporting periods beginning on or after 1 January 2023, with earlier application permitted.

In response to feedback and enquiries from some stakeholders, the Committee discussed how an entity applies the IAS 1 amendments to particular fact patterns. Specifically, the Committee discussed how an entity, applying paragraph 69(d) of IAS 1, determines whether it has the right to defer settlement of a liability for at least twelve months after the reporting period when (a) the right to defer settlement is subject to the entity complying with specified conditions; and (b) compliance with the specified conditions is tested at a date after the end of the reporting period. In the fact patterns discussed, it is assumed that the criteria in paragraph 69(a)–(c) of IAS 1 are not met.

#### **Fact patterns**

The Committee discussed three fact patterns with a loan that requires an entity to maintain a particular working capital ratio. In all fact patterns, the entity is assessing whether it classifies the loan as current or non-current at the end of the reporting period (31 December 20X1).

##### *Case 1*

An entity has a loan with the following contractual terms:

- a. the loan is repayable in five years (ie at 31 December 20X6).
- b. the loan includes a covenant that requires a working capital ratio above 1.0 at each 31 December, 31 March, 30 June and 30 September. The loan becomes repayable on demand if this ratio is not met at any of these testing dates.
- c. the entity's working capital ratio at 31 December 20X1 is 0.9 but the entity obtains a waiver before the reporting date with respect to the breach at that date. The waiver is for three months. Compliance with the covenant on the other testing dates continues to be required.
- d. the entity expects the working capital ratio to be above 1.0 at 31 March 20X2 (and the other testing dates in 20X2).

## Case 2

The fact pattern is the same as Case 1 except:

- a. instead of the condition described in Case 1, the covenant requires a working capital ratio above 1.0 at each 31 March (ie the ratio is tested only once a year at 31 March). The loan becomes repayable on demand if the ratio is not met at any testing date.
- b. the entity's working capital ratio at 31 December 20X1 is 0.9. The entity expects the working capital ratio to be above 1.0 at 31 March 20X2.

## Case 3

The fact pattern is the same as Case 1 except:

- a. instead of the condition described in Case 1, the covenant requires a working capital ratio above 1.0 at 31 December 20X1 and above 1.1 at 30 June 20X2 (and at each 30 June thereafter). The loan becomes repayable on demand if the ratio is not met at any of these testing dates.
- b. the entity's working capital ratio at 31 December 20X1 is 1.05. The entity expects the working capital ratio to be above 1.1 at 30 June 20X2.

## Application of IAS 1 to the fact patterns

Paragraph 69(d) of IAS 1 specifies that an entity classifies a liability as current when 'it does not have the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period'. Paragraphs 72A and 75 of IAS 1 provide related application requirements.

### Case 1

The entity's right to defer settlement of the loan for at least twelve months after the reporting period is subject to the entity complying with a specified condition—a working capital ratio above 1.0 at 31 March, 30 June, 30 September and 31 December 20X2. The entity does not comply with the condition at the end of the reporting period because its working capital ratio is 0.9.

The entity obtains a waiver from the lender but the waiver is for only three months after the reporting period. Paragraph 75 of IAS 1 states that 'an entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period'.

Accordingly, the Committee concluded that the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least twelve months after the reporting period.

### Case 2

The entity's right to defer settlement of the loan for at least twelve months after the reporting period is subject to the entity complying with a specified condition—a working capital ratio above 1.0 at 31 March 20X2.

Paragraph 72A of IAS 1 states that ‘if the right to defer settlement is subject to the entity complying with specified conditions, the right exists at the end of the reporting period only if the entity complies with those conditions at the end of the reporting period. The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date’. The entity does not comply with the condition at the end of the reporting period because its working capital ratio is 0.9.

Accordingly, the Committee concluded that the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least twelve months after the reporting period.

### Case 3

The entity’s right to defer settlement of the loan for at least twelve months after the reporting period is subject to the entity complying with two specified conditions—a working capital ratio above 1.0 at 31 December 20X1 and a working capital ratio above 1.1 at 30 June 20X2.

Paragraph 72A of IAS 1 states that ‘if the right to defer settlement is subject to the entity complying with specified conditions, the right exists at the end of the reporting period only if the entity complies with those conditions at the end of the reporting period. The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date’. The entity has a working capital ratio of 1.05 at 31 December 20X1. Therefore the entity complies with the condition tested at that date (a working capital ratio above 1.0) but does not comply with the condition that will be tested at 30 June 20X2 (a working capital ratio above 1.1).

Accordingly, the Committee concluded that the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least twelve months after the reporting period.

### Conclusion

In all three fact patterns described in this agenda decision, the Committee concluded that the entity is required to classify the loan as current because the entity does not have the right at the end of the reporting period (31 December 20X1) to defer settlement of the loan for at least twelve months after the reporting period.

In reaching its conclusion, the Committee noted that the entity’s expectation that it will meet the condition tested after the reporting period does not affect its assessment of the criterion in paragraph 69(d) of IAS 1. Applying paragraphs 69(d) and 72A of IAS 1, the entity’s right to defer settlement of a liability for at least twelve months after the reporting period must exist at the end of the reporting period.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for the entity to determine how to classify the loan as current or non-current in the three fact patterns described in the agenda decision. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

### **Attributing Benefit to Periods of Service (IAS 19 *Employee Benefits*)—Agenda Paper 3**

The Committee received a request about the periods of service to which an entity attributes benefit for a particular defined benefit plan. Under the terms of the plan:

- a. employees are entitled to a lump sum benefit payment when they reach a particular retirement age provided they are employed by the entity when they reach that retirement age; and
- b. the amount of the retirement benefit to which an employee is entitled depends on the length of employee service before the retirement age and is capped at a specified number of consecutive years of service.

To illustrate the fact pattern described in the request, assume an entity sponsors a defined benefit plan for its employees. Under the terms of the plan:

- a. employees are entitled to a retirement benefit only when they reach the retirement age of 62 provided they are employed by the entity when they reach that retirement age;
- b. the amount of the retirement benefit is calculated as one month of final salary for each year of service before the retirement age;
- c. the retirement benefit is capped at 16 years of service (ie the maximum retirement benefit an employee is entitled to is 16 months of final salary); and
- d. the retirement benefit is calculated using only the number of consecutive years of employee service immediately before the retirement age.

Paragraph 70 of IAS 19 specifies the principle for attributing benefit to periods of service and paragraphs 71–74 of IAS 19 include requirements that specify how an entity applies that principle. Paragraph 71 requires an entity to attribute benefit to periods in which the obligation to provide post-employment benefits arises. That paragraph also specifies that the obligation arises as employees render services in return for post-employment benefits an entity expects to pay in future reporting periods. Paragraph 72 specifies that employee service before any vesting date gives rise to a constructive obligation because, at the end of each successive reporting period, the amount of future service an employee will have to render before becoming entitled to the benefit is reduced.

For the defined benefit plan illustrated in this agenda decision:

- a. if an employee joins the entity before the age of 46 (ie there are more than 16 years before the employee's retirement age), any service the employee renders before the age of 46 does not reduce the amount of future service the employee will have to render in each successive reporting period before becoming entitled to the retirement benefit. Employee service before the age of 46 affects neither the timing nor the amount of the retirement benefit. Accordingly, the entity's obligation to provide retirement benefits arises only from the age of 46.
- b. if an employee joins the entity on or after the age of 46, the amount of future service the employee will have to render before becoming entitled to the retirement benefit is reduced at the end of each successive reporting period. Accordingly, the entity's obligation to provide retirement benefits arises from the date the employee first renders service.

Paragraph 73 of IAS 19 specifies that an entity's obligation increases until the date when further service by the employee will lead to no material amount of further benefits under the plan. The Committee observed that:

- a. each year of service between the age of 46 and the age of 62 leads to further benefits because service rendered in each of those years reduces the amount of future service an employee will have to render before becoming entitled to the retirement benefit; and
- b. an employee will receive no material amount of further benefits from the age of 62, regardless of the age at which the employee joins the entity. The entity therefore attributes retirement benefit only until the age of 62.

Consequently, for the defined benefit plan illustrated in this agenda decision, the Committee concluded that the entity attributes retirement benefit to each year in which the employee renders service from the age of 46 to the age of 62 (or, if employment commences on or after the age of 46, from the date the employee first renders service to the age of 62). The Committee's conclusion aligns with the outcome set out in Example 2 illustrating paragraph 73, which is part of IAS 19.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine the periods to which retirement benefit is attributed in the fact pattern described in the request. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

### **Configuration or Customisation Costs in a Cloud Computing Arrangement (IAS 38 Intangible Assets)—Agenda Paper 5**

The Committee received a request about the customer's accounting for costs of configuring or customising the supplier's application software in a Software as a Service (SaaS) arrangement. In the fact pattern described in the request:

- a. a customer enters into a SaaS arrangement with a supplier. The contract conveys to the customer the right to receive access to the supplier's application software over the contract term—that right to receive access does not provide the customer with a software asset at the contract commencement date. Therefore, the access to the software is a service that the customer receives over the contract term.
- b. the customer incurs upfront costs of configuring or customising the supplier's application software to which the customer receives access. The request describes configuration and customisation as follows:
  - i. configuration involves the setting of various 'flags' or 'switches' within the application software, or defining values or parameters, to set up the software's existing code to function in a specified way.
  - ii. customisation involves modifying the software code in the application or writing additional code. Customisation generally changes, or creates additional, functionalities within the software.

In analysing the request, the Committee considered:

- a. whether, applying IAS 38, the customer recognises an intangible asset in relation to configuration or customisation of the application software (Question I)?
- b. if an intangible asset is not recognised, how the customer accounts for the configuration or customisation costs (Question II)?

## **Does the customer recognise an intangible asset in relation to configuration or customisation of the application software (Question I)?**

Applying paragraph 18 of IAS 38, an entity recognises an item as an intangible asset when the entity demonstrates that the item meets both the definition of an intangible asset and the recognition criteria in paragraphs 21–23 of IAS 38. IAS 38 defines an intangible asset as ‘an identifiable non-monetary asset without physical substance’. IAS 38 notes that an asset is a resource controlled by an entity and paragraph 13 specifies that an entity controls an asset if it has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits.

In the fact pattern described in the request, the supplier controls the application software to which the customer has access. The assessment of whether configuration or customisation of that software results in an intangible asset for the customer depends on the nature and output of the configuration or customisation performed. The Committee observed that, in the SaaS arrangement described in the request, the customer often would not recognise an intangible asset because it does not control the software being configured or customised and those activities do not create an asset that is separate from the software. In some circumstances however, the arrangement may result in, for example, additional code from which the customer has the power to obtain the future economic benefits and to restrict others’ access to those benefits. In that case, the customer assesses whether the additional code is identifiable and meets the recognition criteria in IAS 38 in determining whether to recognise the additional code as an intangible asset.

## **If an intangible asset is not recognised, how does the customer account for the configuration or customisation costs (Question II)?**

If the customer does not recognise an intangible asset in relation to configuration or customisation of the application software, it applies paragraphs 68–70 of IAS 38 to account for those costs. The Committee observed that:

- a. the customer recognises the costs as an expense when it receives the configuration or customisation services (paragraph 69). Paragraph 69A specifies that ‘services are received when they are performed by a supplier in accordance with a contract to deliver them to the entity and not when the entity uses them to deliver another service...’. In assessing when to recognise the costs as an expense, IAS 38 therefore requires the customer to determine when the supplier performs the configuration or customisation services in accordance with the contract to deliver those services.
- b. IAS 38 does not include requirements that deal with the identification of the services the customer receives and when the supplier performs those services in accordance with the contract to deliver them. Paragraphs 10–11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* require the customer to refer to, and consider the applicability of, the requirements in IFRS Standards that deal with similar and related issues. The Committee observed that IFRS 15 *Revenue from Contracts with Customers* includes requirements that suppliers apply in identifying the promised goods or services in a contract with a customer and when those promised goods or services are transferred to the customer. In the fact pattern described in the request, those requirements in IFRS 15 deal with issues similar and related to those faced by the customer in determining when the supplier performs the configuration or customisation services in accordance with the contract to deliver those services.

- c. in referring to the requirements in IFRS 15 to determine when the supplier performs the configuration or customisation services in accordance with the contract to deliver them:
  - i. if the services the customer receives are distinct, then the customer recognises the costs as an expense when the supplier configures or customises the application software.
  - ii. if the services the customer receives are not distinct (because those services are not separately identifiable from the customer's right to receive access to the supplier's application software), then the customer recognises the costs as an expense when the supplier provides access to the application software over the contract term.
- d. if the customer pays the supplier before receiving the services, it recognises the prepayment as an asset (paragraph 70 of IAS 38).

Paragraphs 117–124 of IAS 1 *Presentation of Financial Statements* require the customer to disclose its accounting policy for configuration or customisation costs when that disclosure is relevant to an understanding of its financial statements.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for a customer to determine its accounting for configuration or customisation costs incurred in relation to the SaaS arrangement described in the request. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

### **Hedging Variability in Cash Flows due to Real Interest Rates (IFRS 9 *Financial Instruments*)—Agenda Paper 6**

The Committee received a request about applying the hedge accounting requirements in IFRS 9 when the risk management objective is to 'fix' the cash flows in real terms.

The request asked whether a hedge of the variability in cash flows arising from changes in the real interest rate, rather than the nominal interest rate, could be accounted for as a cash flow hedge. More specifically, the request describes a fact pattern in which an entity with a floating rate instrument referenced to an interest rate benchmark, such as LIBOR, enters into an inflation swap (which swaps the variable interest cash flows of the floating rate instrument for variable cash flows based on an inflation index). The request asked whether the entity can designate the swap in a cash flow hedging relationship to hedge changes in the variable interest payments for changes in the real interest rate.

#### **Hedge accounting requirements in IFRS 9**

Paragraph 6.1.1 of IFRS 9 states that the objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (or other comprehensive income).

One type of hedging relationship described in paragraph 6.5.2 of IFRS 9 is a cash flow hedge in which an entity hedges the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability and could affect profit or loss.

Paragraph 6.3.7 of IFRS 9 specifies that an entity may designate an item in its entirety, or a component of an item, as a hedged item. A risk component may be designated as the hedged



item if, based on an assessment within the context of the particular market structure, that risk component is separately identifiable and reliably measurable.

With respect to inflation risk, paragraph B6.3.13 of IFRS 9 states ‘there is a rebuttable presumption that unless inflation risk is contractually specified, it is not separately identifiable and reliably measurable and hence cannot be designated as a risk component of a financial instrument’.

Paragraph B6.3.14 of IFRS 9 states that an entity cannot simply impute the terms and conditions of an inflation hedging instrument by projecting its term and conditions onto nominal interest rate debt. This is because, when developing IFRS 9, the Board specifically considered inflation risk and put in place restrictions to address its concern that entities might impute the terms and conditions of a hedging instrument onto the hedged item ‘without proper application of the criteria for designating risk components’ as a hedged item (paragraph BC6.193 of IFRS 9). To appropriately account for hedge (in)effectiveness, paragraph B6.5.5 of IFRS 9 requires an entity to measure the (present) value of the hedged item independently of the measurement of the value of the hedging instrument.

Given the request asked whether the real interest rate component could be designated as a risk component, the Committee’s analysis focussed on whether a non-contractually specified real interest rate risk component is separately identifiable and reliably measurable in the proposed cash flow hedging relationship described in the request.

### **Can a non-contractually specified real interest rate risk component be designated as the hedged item in a cash flow hedging relationship?**

To apply cash flow hedge accounting in the fact pattern described in the request, the Committee considered that it would be necessary to determine:

- a. whether the floating rate instrument has exposure to variability in cash flows that are attributable to the real interest rate risk component as required by paragraph 6.5.2(b) of IFRS 9; and
- b. whether that risk component is separately identifiable and reliably measurable as required by paragraph 6.3.7 of IFRS 9.

The Committee noted that a nominal interest rate comprises a real interest rate, an inflation component (for example, breakeven inflation and inflation premium), and other components (for example a liquidity premium). Unlike a currency, inflation varies based on the underlying methodology used to determine actual inflation (and can vary within a currency area). This means, even within a jurisdiction, there can be multiple rates of inflation depending on the inflation index to which the financial instrument is referenced—for example, a retail price index, consumer price index or another inflation index.

The Committee observed that, to meet the requirements in IFRS 9 for a cash flow hedge designation, the variability of individual cash flow streams attributed to the designated risk component needs to be separately identifiable in currency or nominal terms. The Committee considered that the interest rate for variable rate financial instruments is defined in nominal terms for a given currency. Each currency unit of cash flow of a financial asset or financial liability (that is, each principal and interest cash flow) is equally exposed to inflation risk. Measurement and forecasts of actual inflation are based on statistical methodologies and therefore entail a time lag. The real interest rate, and therefore the effect of inflation, is not a risk component that explicitly or

implicitly influences the determination of a nominal benchmark interest rate. There is therefore no identifiable variability in the benchmark rate-based nominal cash flows (for example, LIBOR cash flows) on a floating rate financial instrument that is attributable to the real interest rate risk component as required by paragraph 6.5.2(b) of IFRS 9.

In addition, the Committee considered that, in the proposed cash flow hedging relationship, the real interest rate would be an implied residual risk component (after combining the variable inflation-linked cash flows and the floating benchmark rate-based cash flows). The Committee therefore concluded that changes in cash flows on a floating rate instrument arising from the real interest rate risk component cannot be identified independently of changes in cash flows arising from other risk components. Consequently, the real interest rate risk component does not meet the requirements in paragraph 6.3.7 of IFRS 9 to be designated as a risk component. It therefore is not an eligible hedged item as required by paragraph 6.4.1 of IFRS 9.

The Committee concluded that the requirements in IFRS 9 provide an adequate basis for an entity to determine whether a hedge of the variability in cash flows arising from changes in the real interest rate, rather than the nominal interest rate, could be accounted for as a cash flow hedge. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

## **Committee’s agenda decisions**

Agenda decisions, in many cases, include explanatory material. Explanatory material may provide additional insights that might change an entity's understanding of the principles and requirements in IFRS Standards. Because of this, an entity might determine that it needs to change an accounting policy as a result of an agenda decision. It is expected that an entity would be entitled to sufficient time to make that determination and implement any necessary accounting policy change (for example, an entity may need to obtain new information or adapt its systems to implement a change). Determining how much time is sufficient to make an accounting policy change is a matter of judgement that depends on an entity's particular facts and circumstances. Nonetheless an entity would be expected to implement any change on a timely basis and, if material, consider whether disclosure related to the change is required by IFRS Standards.

The Committee discussed the following matter and decided not to add a standard-setting project to the work plan.<sup>1</sup>

### **Supply Chain Financing Arrangements—Reverse Factoring—Agenda Paper 4**

The Committee received a request about reverse factoring arrangements. Specifically, the request asked:

- a. how an entity presents liabilities to pay for goods or services received when the related invoices are part of a reverse factoring arrangement; and
- b. what information about reverse factoring arrangements an entity is required to disclose in its financial statements.

In a reverse factoring arrangement, a financial institution agrees to pay amounts an entity owes to the entity’s suppliers and the entity agrees to pay the financial institution at the same date as, or a date later than, suppliers are paid.

#### **Presentation in the statement of financial position**

IAS 1 *Presentation of Financial Statements* specifies how an entity is required to present its liabilities in the statement of financial position.

Paragraph 54 of IAS 1 requires an entity to present ‘trade and other payables’ separately from other financial liabilities. ‘Trade and other payables’ are sufficiently different in nature or function from other financial liabilities to warrant separate presentation (paragraph 57 of IAS 1). Paragraph 55 of IAS 1 requires an entity to present additional line items (including by disaggregating the line items listed in paragraph 54) when such presentation is relevant to an understanding of the entity’s financial position. Consequently, an entity is required to determine whether to present liabilities that are part of a reverse factoring arrangement:

- a. within trade and other payables;
- b. within other financial liabilities; or
- c. as a line item separate from other items in its statement of financial position.

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<sup>1</sup> [In accordance with paragraph 8.7 of the *Due Process Handbook*, at the December 2020 Board meeting the Board discussed, and did not object to, this agenda decision.]

Paragraph 11(a) of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* 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’. Paragraph 70 of IAS 1 explains that ‘some current liabilities, such as trade payables... are part of the working capital used in the entity’s normal operating cycle’. The Committee therefore concluded that an entity presents a financial liability as a trade payable only when it:

- a. represents a liability to pay for goods or services;
- b. is invoiced or formally agreed with the supplier; and
- c. is part of the working capital used in the entity’s normal operating cycle.

Paragraph 29 of IAS 1 requires an entity to ‘present separately items of a dissimilar nature or function unless they are immaterial’. Paragraph 57 specifies that line items are included in the statement of financial position when the size, nature or function of an item (or aggregation of similar items) is such that separate presentation is relevant to an understanding of the entity’s financial position. Accordingly, the Committee concluded that, applying IAS 1, an entity presents liabilities that are part of a reverse factoring arrangement:

- a. as part of ‘trade and other payables’ only when those liabilities have a 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.
- b. separately when the size, nature or function of those liabilities makes separate presentation relevant to an understanding of the entity’s financial position. In assessing whether it is required to present such liabilities separately (including whether to disaggregate trade and other payables), an entity considers the amounts, nature and timing of those liabilities (paragraphs 55 and 58 of IAS 1).

The Committee observed that an entity assessing whether to present liabilities that are part of a reverse factoring arrangement separately might consider factors including, for example:

- a. whether additional security is provided as part of the arrangement that would not be provided without the arrangement.
- b. the extent to which the terms of liabilities that are part of the arrangement differ from the terms of the entity’s trade payables that are not part of the arrangement.

### **Derecognition of a financial liability**

An entity assesses whether and when to derecognise a liability that is (or becomes) part of a reverse factoring arrangement applying the derecognition requirements in IFRS 9 *Financial Instruments*.

An entity that derecognises a trade payable to a supplier and recognises a new financial liability to a financial institution applies IAS 1 in determining how to present that new liability in its statement of financial position (see ‘Presentation in the statement of financial position’).

### **Presentation in the statement of cash flows**

Paragraph 6 of IAS 7 *Statement of Cash Flows* defines:

- a. operating activities as ‘the principal revenue-producing activities of the entity and other activities that are not investing or financing activities’; and

- b. financing activities as ‘activities that result in changes in the size and composition of the contributed equity and borrowings of the entity’.

An entity that has entered into a reverse factoring arrangement determines how to classify cash flows under the arrangement, typically as cash flows from operating activities or cash flows from financing activities. The Committee observed that an entity’s assessment of the nature of the liabilities that are part of the arrangement may help in determining whether the related cash flows arise from operating or financing activities. For example, if the entity considers the related liability to be a trade or other payable that is part of the working capital used in the entity’s principal revenue-producing activities, the entity presents cash outflows to settle the liability as arising from operating activities in its statement of cash flows. In contrast, if the entity considers that the related liability is not a trade or other payable because the liability represents borrowings of the entity, the entity presents cash outflows to settle the liability as arising from financing activities in its statement of cash flows.

Investing and financing transactions that do not require the use of cash or cash equivalents are excluded from an entity’s statement of cash flows (paragraph 43 of IAS 7). Consequently, if a cash inflow and cash outflow occur for an entity when an invoice is factored as part of a reverse factoring arrangement, the entity presents those cash flows in its statement of cash flows. If no cash inflow or cash outflow occurs for an entity in a financing transaction, the entity discloses the transaction elsewhere in the financial statements in a way that provides all the relevant information about the financing activity (paragraph 43 of IAS 7).

### **Notes to the financial statements**

Paragraph 31 of IFRS 7 *Financial Instruments: Disclosures* requires an entity to provide information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed. IFRS 7 defines liquidity risk as ‘the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset’. The Committee observed that reverse factoring arrangements often give rise to liquidity risk because:

- a. the entity has concentrated a portion of its liabilities with one financial institution rather than a diverse group of suppliers. The entity may also obtain other sources of funding from the financial institution providing the reverse factoring arrangement. If the entity were to encounter any difficulty in meeting its obligations, such a concentration would increase the risk that the entity might have to pay a significant amount, at one time, to one counterparty.
- b. the entity may have become reliant on extended payment terms or the entity’s supplier may have become accustomed to, or reliant on, earlier payment under the reverse factoring arrangement. If the financial institution were to withdraw the reverse factoring arrangement, that withdrawal could affect the entity’s ability to settle liabilities when they are due, particularly if the entity were already in financial distress.

Paragraphs 33–35 of IFRS 7 require an entity to disclose how exposures to risk arising from financial instruments, including liquidity risk, arise; the entity’s objectives, policies and processes for managing the risk; summary quantitative data about the entity’s exposure to liquidity risk at the end of the reporting period (including further information if this data is unrepresentative of the entity’s exposure to liquidity risk during the period); and concentrations of risk. Paragraphs 39 and B11F of IFRS 7 specify further requirements and factors an entity might consider in providing liquidity risk disclosures.

An entity applies judgement in determining whether to provide additional disclosures in the notes about the effect of reverse factoring arrangements on its financial position, financial performance and cash flows. The Committee observed that:

- a. assessing how to present liabilities and cash flows related to reverse factoring arrangements may involve judgement. An entity discloses the judgements that management has made in this respect if they are among the judgements made that have the most significant effect on the amounts recognised in the financial statements (paragraph 122 of IAS 1).
- b. reverse factoring arrangements may have a material effect on an entity's financial statements. An entity provides information about reverse factoring arrangements in its financial statements to the extent that such information is relevant to an understanding of any of those financial statements (paragraph 112 of IAS 1).

The Committee noted that making materiality judgements involves both quantitative and qualitative considerations.

Paragraph 44A of IAS 7 requires an entity to provide 'disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes'. The Committee noted that such disclosure is required for liabilities that are part of a reverse factoring arrangement if the cash flows for those liabilities were, or future cash flows will be, classified as cash flows from financing activities.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine the presentation of liabilities that are part of reverse factoring arrangements, the presentation of the related cash flows, and the information to disclose in the notes about, for example, liquidity risks that arise in such arrangements. Consequently, the Committee decided not to add a standard-setting project on these matters to the work plan.

#### ***Agenda paper 4: Report to the Board***

Respondents to the tentative agenda decision provided input on possible standard-setting the Board could undertake in relation to supply chain financing arrangements. The Board will consider at a future Board meeting whether to undertake such standard-setting, considering the feedback from those respondents, as well as feedback received from Committee members, users of financial statements and other interested parties.

## **Other matters**

### **Work in Progress—Agenda Paper 7**

The Committee received an update on the current status of open matters not discussed at its meeting in December 2020.