21 March 2018

Dear Mr. Field, dear Ms. Reeves,

I am writing in response to your letter of 14 March 2018, setting out a number of questions on the accounting for reverse factoring arrangements. Our responses to your specific questions are attached.

Should it be helpful we would be happy to provide a further briefing for the Committee.

Sir Winfried Bischoff
Chairman
Summary
Whilst there is limited guidance specifically focused on reverse factoring, there are accounting standard requirements that are relevant in determining the appropriate accounting policies. Applying these standards requires significant professional judgement, particularly as reverse factoring arrangements can differ greatly; the most appropriate policy will be dependent on the specific terms and conditions that form the arrangement. When such arrangements are material, directors must provide such disclosures and explanations as are necessary to present a true and fair view.

As you are aware we have announced two separate investigations into Carillion and it is important that we do not prejudice those investigations. Accordingly, for the most part our response seeks to deal with the issues of reverse factoring generically rather than in the specific circumstances of Carillion.

An overview of reverse factoring arrangements
Reverse factoring is an umbrella term for a range of supply-chain financing arrangements. Whilst they have a number of key commonalities, the detailed terms and conditions of each arrangement and the motivations of the parties involved can differ greatly. Such differences can result in different accounting treatments when best presenting the substance and nature of the transactions.

In essence, all such arrangements are intended to result in suppliers receiving cash for the goods and services they have supplied on an earlier date than the customer pays that cash – the timing difference is bridged by a financial institution, usually a bank.

In some cases, the bank pays the supplier in full and is then reimbursed by the customer. In other cases, the customer pays the supplier, who then reimburses the bank for its earlier “prepayment” of the obligation.

In some situations, the objective is to pay the supplier earlier than the due date, especially where the supplier offers an early payment discount in its usual terms. The supplier receives its cash earlier, albeit after the discount it has offered, whilst the customer is able to settle with the bank on the due date. The benefit of the early payment discount will then fall to the bank or be shared between the bank and the customer. The customer can, in some cases, be doing little more than assisting the supplier in raising working capital finance.

In other situations, the objective is to effectively extend the customer’s credit terms without any improvement to the supplier’s cash flows – the supplier is paid on the full due date, but the bank provides a period of extended credit to the customer for a fee and/or interest charges. In such cases, the economic substance is far more akin to a bank loan.

What is clear, in all situations, is that the customer continues to present a liability in its balance sheet until it pays cash out to ultimately settle for the goods and services it has received. What is at issue, is whether this liability that originally arises on the supply of goods and services is appropriately shown as owed to the supplier (as trade payables) or some other party (e.g. as some form of borrowings from a bank).

Similarly, if there is only one cash outflow from the customer (e.g. to the bank, who has paid the supplier) there is a question as to whether this is best presented in the cash flow statement as an operational cash flow (i.e. to pay for goods and services) or a cash flow to settle a debt financing arrangement. The answers to these questions requires the application of professional judgement in the light of the extant accounting standards.
Responses to your specific questions:

1) **How widespread is the use of reverse factoring arrangements?**

We do not collate information on the extent to which reverse factoring arrangements are used, nor the extent to which their use is disclosed in financial statements. It is possible that such arrangements could be used by a company but not to an extent that is material to its financial statements.

We understand, however, that the use of supply chain finance (‘SCF’) has grown over recent years with some correlation identified by suppliers of such finance with an increased focus on working capital management since the financial crisis. We also understand, that the complexity of such arrangements has increased in recent years.

2) **Could you confirm whether there is a specific accounting requirement relating to reverse factoring facilities?**

Whilst there is no specific reference in the accounting standards to reverse factoring or SCF, guidance can be taken from a number of standards.

- **IAS 39 ‘Financial Instruments: Recognition and Measurement’** (recently replaced by IFRS 9 ‘Financial Instruments’) addresses the derecognition of financial liabilities. Its requirements are relevant in assessing the appropriate presentation of the liability arising from SCF arrangements. In particular, consideration must be given to whether the original “trade payable” liability is extinguished (i.e. the customer is legally released from its invoiced obligation to the supplier) or its terms amended to such an extent that its replacement with a new debt-like liability is appropriate.

  Consideration of quantitative and qualitative factors, including the detailed terms of the arrangement, will be necessary when performing this assessment.

- **IAS 1 ‘Presentation of Financial Statements’** requires that entities present separate line items on the balance sheet for trade and other payables and other financial liabilities. Additional line items are also required, where relevant, to gain an understanding of the entity’s financial position – either on the face of the balance sheet or in the notes to the accounts.

  These IAS 1 requirements provide a framework for determining the structure of an entity’s balance sheet. Liabilities that are financing in nature are normally presented together and described as debt or financial liabilities, and liabilities that are working capital in nature are normally presented within trade and other payables.

  If the presentation and classification of the liability constituted a critical accounting judgement for the entity, IAS 1 would require additional disclosures.

- **IAS 7 ‘Statement of Cash Flows’** requires entities to classify cash flows according to whether they arise from operating, financing or investing activities – and consistency between the statement of cash flows and the balance sheet can be expected. Therefore, the definitions of operating and financing activities might also assist entities in determining the appropriate presentation of liabilities arising from reverse factoring. The classification within the cash flow...
statement should reflect the substance of the arrangement which requires some judgement.

The application of the above standards, particularly the application of IAS 39/IFRS 9, may involve a high level of judgement in order to determine and reflect the substance of the arrangement, and conclusions can only be drawn with reference to the specific facts and circumstances of each individual SCF arrangement.

The above accounting standards provide a framework for the application of professional judgement in presenting the impact of SCF arrangements. Furthermore, the overriding legal requirement that financial statements should present a true and fair view places an onus on companies to provide such disclosure as is necessary to do so. As discussed below we encourage disclosure of complex supply chain arrangements.

However, the growth in the use of SCF arrangements and their increased complexity may have reached a point where the International Financial Reporting Standards should explicitly and more comprehensively address them. We will consider this further and present our findings to the International Accounting Standards Board.

3) How does the FRC expect such arrangements to be accounted for, particularly in respect of recording liabilities and the disclosure of relevant information in cash flow statements? How are companies made aware of this position?

The FRC expects the accounting standards referred to above to be applied by entities with SCF agreements in place, taking into consideration the facts and circumstances of each individual arrangement. Where an entity uses reverse factoring to such an extent that there is a material impact on the year’s financial performance or position, additional disclosures would be expected to explain the nature of arrangements, the accounting policies applied, and any significant accounting judgements made.

In December 2014, the FRC released a statement calling for Boards of retailers, suppliers and other businesses to provide investors with sufficient information about their accounting policies, judgements and estimates which arise from complex supplier arrangements.

A report published by the FRC’s Financial Reporting Lab also reinforced the value investors place on understanding each judgement and each estimate which has an impact on the reporting of a company’s results and financial position.

The European Securities and Markets Authority drew attention to reverse factoring in its 2015 European common enforcement priorities, stating that issuers should analyse the substance of the arrangements when presenting financial liabilities and classifying associated cash flows, and encouraged disclosure of:

- the accounting policy applied to the classification;
- the judgements made; and
- a description of the relevant provisions of the arrangements, the quantitative impact on the financial statements and how the arrangements were used to manage liquidity needs.

The FRC also published a letter to audit committee chairs and finance directors in October 2017 ahead of the 2017/18 reporting season, with the FRC’s perspective on
aspects of annual reports that companies should aim to improve and to highlight changes to UK reporting requirements. One of the issues highlighted was the amendments made to IAS 7. We pointed out that an explanation of changes in a company's financing obligations over the period was a new disclosure requirement, which provides an opportunity for companies to improve the clarity of their disclosures, particularly in those areas where investors have voiced disappointment, such as the presentation of the use of invoice discounting arrangements. We noted that it was sometimes unclear whether operating cash flows recorded represented cash received from the customer or cash received from the financial provider of these facilities. The lack of disclosure in this area, particularly in non-recourse arrangements where the customer receivables are derecognised, may hide reliance that a company has on such facilities. We therefore encouraged companies to provide detail of, and disclosure of reliance upon, these types of facilities.

These comments were reiterated in January 2018, when the FRC published a statement in response to the collapse of Carillion, addressing the accounting and reporting framework for the construction and business support services sectors. In that statement we reiterated the importance of disclosing significant accounting judgements and referred to the importance of disclosing clear information about levels of debt, cash flows and the conversion (including the processes of conversion, such as invoice discounting and reverse factoring) of operating profits into cash.

4) **Was Carillion’s approach to its reverse factoring facility in line with the FRC’s expectation?**

Carillion’s accounts provide no significant material disclosures on their use of reverse factoring arrangements and therefore, in the absence of further information, it is impossible to determine, at this stage, whether Carillion’s approach was in line with our expectations.

It is possible that derecognition of the original trade payable was appropriate under IAS 39, but that because there were no significant changes to the payment terms, it was still appropriate to disclose the replacement liability (i.e. the amounts due to their intermediary) within trade and other payables. To draw conclusions, we would require specific information about the terms of Carillion’s factoring facility agreements, the extent to which they are used and an explanation of management’s judgements. However, it would not be appropriate to do so pending the outcome of our investigations.

5) **Is it normal for a reverse factoring arrangement potentially to account for 98% of a Company’s cash inflow?**

We do not monitor the source and extent of company finance so are unable to provide quantitative analysis to support an answer to this question.

However, as you further consider this matter we note that Moody’s are not referring to the company’s total gross cash inflows (i.e. the sum of only the cash received), but to the net cash flows that relate to operating activities only (i.e. excluding financing and investing) — i.e. they are noting that the increase in other creditors (that they believe to be due to the increased amounts owed to the bank under the arrangement) is equal to 98% of the net cash inflows from operations.
As mentioned above, the presentation of cash outflows (as either operational cash flows to pay for goods and services or financing cashflows to settle debt) may be a key area of judgement dependent on the terms of the arrangement in place.

Moody’s point is not that there was an actual cash inflow from the bank. Rather, they are highlighting that including the increase in other creditors in the calculation of cash flows from operations, could give a potentially misleading impression of how cash from operations is retained.

To summarise, the arrangement did result in Carillion retaining cash for longer - the total net cash inflows were higher. But, without disclosures about the use and impact of reverse factoring, it is not clear that this has been achieved by the bank paying on Carillion’s behalf and a new and different liability being recognised.

6) Can published accounts be considered fully transparent and reliable if cash flow statements and balance sheets do not enable users to establish whether a company is making use of reverse factoring arrangements?

This is dependent on whether disclosures on the use of such arrangements are material to an understanding of the financial position, performance and cashflows of the company and, ultimately, necessary for the financial statements to give a true and fair view. As noted above, where such arrangements are material then explanations should be given and we have highlighted this in a number of published documents.

7) Did any of your previous correspondence with Carillion about the adequacy of their disclosures raise the issue of reverse factoring arrangements?

The FRC’s Corporate Reporting Review (CRR) team reviewed Carillion’s December 2015 accounts and the December 2011 accounts. When conducting a Review, we raise questions where there is, or may be, a question of non-compliance with the reporting requirements. This may be an indication that something may be incorrect, that relevant information has been omitted, or that there are apparent inconsistencies that have not been explained. Reverse factoring was not raised since it was not apparent from a review of the report and accounts that there was a question of non-compliance.

We determine whether to raise questions by taking the report and accounts as a whole, that is, including the disclosures provided in the strategic report. In addition to considering whether the strategic report satisfies the legal requirements, we also consider whether the content is consistent with the information disclosed in the accounts. For example, if a company were to refer to reverse factoring facilities as being a key feature of their working capital facilities in their strategic report, but there was no information disclosed about the accounting policies (or their application) for such facilities in the accounts, this would likely prompt a question from us. If there is no evidence that suggests there has been such an omission then we would not raise a question.

The FRC Enforcement Division’s investigation into the preparation and approval of the financial statements of Carillion will include consideration of Carillion’s use of reverse factoring arrangements and whether the accounting treatment adopted was appropriate.