IFRS Foundation
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28th September 2020

Dear Board Members and Staff,

Thank you for the opportunity to comment on your tentative agenda decision on reverse factoring arrangements. The European Leveraged Finance Association (ELFA) is a professional trade association comprised of European leveraged finance investors with more than 30 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants.

Our members view the application of current reporting standards to receivables factoring and reverse factoring as particularly problematic for the following reasons:

- Our members consider the liabilities originated by such liabilities to be debt-like liabilities because terms generally enable earlier payment to suppliers and later payment by customers. The funding gap that is so generated is bridged by a bank or other financial institutions, similar to other conventional form of funding.
- Our members find that such arrangements are frequently not disclosed in annual and quarterly reports, resulting in under-reported financial debt. This is particularly problematic for leveraged finance investors making their investment decisions based on reported financial debt, as they would be unaware of the additional leverage funded through such arrangements. Therefore, when such arrangements are not disclosed, investors may misallocate capital and misprice credit risk. This is also problematic for equity investors as under reported financial debt might translate into inflated market equity valuations.
- Default risk is a key consideration for leveraged finance investors and the risk can be exacerbated by these arrangements, which are generally short-term in nature and can be pulled at short notice. When banks pull out of these lines, the resulting working capital shock can potentially trigger a liquidity crisis that could lead to the issuer's default, without any warning sign for investors. When these arrangements are not disclosed, leverage finance investors are unaware of this additional source of default risk, compounding the capital allocation and pricing challenge described in the previous point. A number of high-profile defaults have abundantly illustrated this point.
- When these arrangements are not disclosed, banks have an asymmetrical information advantage vs. debt capital market investors which undermines a key tenet of efficient capital markets (i.e., that the same information is made available to all investors).

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For these reasons ELFA supports Moody's letter to strengthen reporting standards applicable to supply chain finance arrangements. In addition to reverse factoring, ELFA would welcome tighter reporting standards for non-recourse receivables factoring as well, since all of the points raised above are also applicable to this form of funding.

Given the importance to our members of strengthening current reporting standards applicable to factoring arrangements, we believe the Board should reconsider adding these matters to its standard setting agenda. We would encourage the Board to take on a narrow-scope project to add specific disclosure requirements for all factoring arrangements, whether receivables factoring or reverse factoring.

In response to your questions:

Question 1: Do you think the information already required by IFRS Standards (as explained in the tentative agenda decision) is sufficient?

Based on the experience of ELFA members we have consulted, the application of current reporting standards is not sufficient to address the issue. Our members have found that such arrangements are frequently undisclosed and sufficiently large in size to add significant credit risk. A recent annual study by the Supply Chain Finance Community and PWC (quoted by Moody's in its report "Reverse factoring is increasingly popular but can weaken liquidity at a time of stress", 19th September 2019) 49% of companies surveyed already operate a reverse factoring programme, yet fewer than 5% of the non-financial companies rated by Moody's disclose such a programme in their public accounts.

With regards to non-recourse receivables factoring (non-recourse sale of trade receivables), such lines are not included among financial liabilities in the balance sheet as they are treated as "true" sale of receivables and are frequently undisclosed in the notes to the financial statements. There is a general consensus among ELFA members that these are a debt-like facilities. In addition to the points raised above, while in theory a non-recourse sale of receivables results in a full transfer of the credit risk associated with customers' payment, in practice banks add them together with conventional debt facilities to calculate aggregate corporate exposure limits.

With regards to reverse factoring, our members find that the liabilities generated by such arrangements are generally reported as trade payables or other payables even when the terms of the liabilities that are part of such arrangement are substantially different from the terms of the companies' trade payables that are not part of the arrangement. Our members have pointed to examples were DPOs (Days Payables Outstanding) were >300 days under reverse factoring arrangements and yet such liabilities were reported as other payables.

Question 2: Is there something missing from the Standards—something the Board should add to the requirements—that is needed to facilitate companies providing useful information about these arrangements? If so, what is missing?

Our members believe that it would be helpful to classify any liability to banks and other financial institutions as financial liabilities regardless of the underlying transaction that has generated such liabilities. Under current reporting standards, a liability to a financial institution generated through supply chain financing arrangements could be classified either as trade payables or other payables even if the initial liability to a supplier is transferred to a bank or other financial institution. Our members believe that when a liability is transferred to a bank or other financial institution, it should be classified as financial liability.

With regards to non-recourse receivables factoring (non-recourse sales of trade receivables), our members believe these are debt-like liabilities for the reasons previously illustrated and although they do not generate a financial liability in its technical definition, they are very similar to other conventional revolving funding agreements. For these reasons our members would welcome a mandatory disclosure in the notes to the financial statements of such liabilities.

We hope that our comments will contribute to the IASB's further deliberation on this topic. Should you require any clarifications, please do not hesitate to contact us.

Your sincerely,

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