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Reverse Factoring: A blind spot for investors

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Reverse Factoring: A blind spot for investors

Executive Summary

- Reverse factoring facilities, whilst useful tool for corporate borrowers, can present significant risks to investors.
- Current disclosure requirements may serve to obfuscate the risks of these arrangements to some companies – the liabilities are not disclosed as debt in the financial statements (but rather under trade payables or other payables), whilst the resulting increase in the cash on balance sheet is reflected.
- Our Disclosure & Transparency Committee has worked to raising awareness of this issue with the International Accounting Standards Board (IASB), lobbying for more transparency.
- The Committee plans to continue its engagement with the IASB, including with respect to conventional factoring and by responding to the IASB's consultation on reverse factoring.

Introduction

Reverse factoring can be useful to businesses as they allow a seller of goods and services to post receivables for an earlier cash payment, whilst permitting businesses to extend the timing of these payables to their suppliers.

The true nature – and potential risk – of such arrangements may be obfuscated under current accounting rules. This is because whilst the arrangement will reflect an increase in the company's cash on balance sheet, the liabilities to the financial institution providing the facility is generally accounted for as trade payables or other payables, instead of either long-term or short-term debt.

The lack of disclosure on such facilities may create a blind spot for investors, as it can result in under-reported financial debt, raising the risk of investors mispricing of credit risk and over-valuing of stocks. Further, they are short-term in nature and can be pulled at short notice, creating the potential for working capital shocks and exacerbating default risk.

ELFA's Disclosure &Transparency Committee has engaged with the IASB through a series of virtual meetings and through their public consultations, involving experts in supply chain finance. We plan to continue our engagement on this and other issues with the aim of supporting more transparency in the leveraged finance market.

Understanding Reverse Factoring

In order to understand reverse factoring, it can help to begin with an overview of conventional factoring. Conventional factoring entails a business's sale of (non-recourse) or borrowing against (invoice discounting) the amounts owed to it by customers. Either form of conventional factoring achieves an earlier cash conversion of trade receivables, thus improving working capital by reducing receivables and consequently the net financial position by increasing cash on balance sheet).

One subtle difference is the accounting treatment in that non-recourse factoring of receivables is treated as a true sale. Therefore, the improved cash position resulting from the transaction is not matched by a financial liability as with invoice discounting, but by a corresponding reduction of receivables.

Reverse factoring and supply chain financing arrangements can take different forms, but in their basic structure, instead of a seller of goods and services posting its receivables for an earlier cash payment, such arrangements allow a business to extend the timing of payables, i.e., the amounts it owes to its suppliers.

This is achieved by allowing suppliers to post their invoices to a financial intermediary for quick payment, while permitting the invoiced business more time to repay the financial intermediary. The benefits of the "reverse" factoring are actually very similar to conventional factoring: improved working capital (by increasing the balance of trade payables) and an improved net financial position (by increasing the cash balance). For a more detailed description of how reverse factoring works, please see Appendix 1.

However, the accounting treatment of reverse factoring arrangements arguably provides a double benefit to the appearance of the borrower's balance sheet. This is because the arrangement increases the company's cash on balance sheet, but the liabilities to the financial institution providing the funding extension are generally accounted for as trade payables or other payables, instead of either long-term or short-term debt.

This therefore flatters the calculation of net financial indebtedness. Without additional disclosure in the footnotes to the financial statements, which is often lacking, investors might be unaware of these debt-like liabilities hiding within payables. For a more detailed description of accounting for factoring, please see Appendix 2.

In order to assess how widespread these funding arrangements are and how frequently they are undisclosed, a recent study by the Supply Chain Finance Community and PWC provides some good insight. According to the study 49% of companies surveyed already operate a reverse factoring programme, yet fewer than 5% disclose such a programme in their public accounts, confirming that reverse factoring is widespread and very rarely disclosed.

This represents a problematic blind spot for investors for the following reasons:

- The lack of disclosure of these liabilities results in under-reported financial debt. This is troubling for both high yield bond and leveraged loan investors, as they are unaware of the additional leverage funded through such arrangements, and equity investors, as under-reported financial debt might translate into inflated market equity valuations. Therefore, when such arrangements are not disclosed, investors may misprice credit risk and over-value stocks.
- Default risk is a key consideration for 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 borrower's default, without any warning sign for investors. The supplier is unlikely to agree to reverting to the old payment terms (i.e., to be paid later) especially given that the bank facility would typically only be pulled at a point when the company is under financial stress. A number of high-profile defaults have abundantly illustrated this point.
- When these arrangements are not disclosed in financial statements, there is a risk of asymmetrical information distributed amongst capital market participants.

A number of high-profile defaults (e.g., Carillon and Abengoa) have illustrated how this instrument can exacerbate default risk. Overdependence on reverse factoring can create a critical vulnerability if the borrower cannot reliably withstand cancellation of the facility, an event that is all the more likely to occur when the credit quality of the borrower deteriorates. Conventional non-recourse receivables factoring represents less of a risk from a liquidity perspective as it is a secured form of funding linked to the credit quality of the borrower's customers, rather than the credit quality of the borrower itself, as is the case for reverse factoring.

Consequences of Reverse Factoring

Carillion plc entered liquidation in January 2018. The size of the company's Early Payment Facility was £498m at the end of 2016, more than double the reported net borrowings of £218.9m. Neither the size of the facility nor year-end drawings were ever disclosed in Carillion's audited accounts.

Abengoa restructured its financial debt in 2016 resulting in severe losses for creditors. The speed and severity of a working capital outflow due to reduced availability of its reverse factoring lines was a key factor in pushing the company into default. Moreover, while Abengoa had reported potentially reassuringly large cash balances in the period leading up to its default, €1.2 billion (49%) of this was actually ring-fenced to support its supplier payment programme, so in practice unavailable as Abengoa's liquidity eroded.

We are not claiming that reverse factoring is a "bad" funding product. It could be structured to provide tangible benefits to the customer base of a strong investment grade credit by improving its collection terms. Our concerns relate to the disclosure gap under current accounting standards that potentially allows companies to hide short term, debt-like liabilities. It represents a particularly problematic blind spot for investors. For this reason, we have continuously lobbied the IASB/IFRS for improved disclosure.

Results of ELFA's lobbying efforts to date, and next steps

In response to a public letter by Moody's submitted on 31st January 2020 (read the full letter here) highlighting the disclosure gaps on reverse factoring arrangements, the IFRS/IASB opened a consultation to assess whether a narrow-scope standard-setting project should be considered to address the matter. In short, the consultation asked whether a change in accounting standards required to deal with the matter.

ELFA Disclosure &Transparency committee was part of this consultation and engaged with the IFRS/IASB through a series of virtual meetings, also involving experts in supply chain finance. We voiced our concerns with current disclosure requirements during these meetings, and our engagement in the consultation culminated with a formal letter published on the IFRS/IASB website (read the full letter here). In the letter, the committee expresses support for reclassifying financial liabilities related to reverse factoring from trade/other payables to financial liabilities.

In December 2020, the IFRS Interpretation Committee concluded that current accounting standards provided an adequate basis for an entity to determine the presentation of liabilities that are part of reverse factoring arrangements. Consequently, the Committee decided not to add a standard-setting project on these matters to their work plan.

This was a disappointing outcome, but on the back of the Greensill implosion, ELFA Disclosure & Transparency committee renewed its lobbying efforts. This culminated in another virtual meeting with IFRS, attended by a number of IAS Board members.

Thankfully at its meeting in June 2021, the IAS Board eventually decided to add a narrow-scope standard-setting project to its work plan on supplier finance arrangements. The IFRS Interpretation committee recommended to the Board the following disclosures:

i. the aggregate amount of payables that are part of the arrangement;
ii. the aggregate amount of the payables disclosed under (i) for which suppliers have already received payment from the finance provider;
iii. the range of payment terms, expressed in time, of payables disclosed under (i); and
iv. the range of payment terms, expressed in time, of trade payables that do not form part of the arrangement.

In addition, the Committee recommended disclosure of the key terms and conditions of the arrangement (including, for example, any extended payment terms and any security or guarantees provided to the finance provider).

The IASB published its exposure draft in the fourth quarter of 2021. ELFA will respond formally to the consultation, which closes on 28 March 2022.

ELFA Disclosure & Transparency Committee views favourably the recommendations from the Interpretation Committee, even if they fall short of our request to reclassify the financial liabilities related to reverse factoring from trade/other payables to financial liabilities.

While waiting for an outcome in the coming months, ELFA's Disclosure & Transparency Committee plans to extend its engagement with IFRS to conventional factoring, as well as other key topics around financial statement reporting where we feel disclosure can be improved.

Appendix 1 – Description of Factoring Arrangements

Conventional factoring

Conventional factoring is a form of invoice finance enabling earlier cash conversion of trade receivables, in many respects similar to invoice discounting. The main difference between the two forms of invoice finance is that under factoring the collection of the invoice is a responsibility of the factoring company and consequently the customer is aware that the invoice has been factored. On the contrary, under invoice discounting facilities, the company takes on the responsibility for the collection of invoice and consequently the customer is not aware of the fact that the invoice has been discounted.

Factoring can be done on a recourse basis or non-recourse basis. Under a factoring arrangement with recourse a company remains liable for any invoice that the factoring company is unable to collect, so it is ultimately liable for any non-payment. On the contrary non-recourse factoring fully, but sometimes only partially, transfers the non-payment risk to the factoring company and it is essentially equivalent to a sale of receivables.

Reverse factoring

While conventional factoring is based upon a purveyor of goods or services obtaining liquidity against payments owed to it, , in reverse factoring a business is looking to borrow against the money that it owes to its suppliersthe (hence “reverse”). Depending on the arrangement, reverse factoring could enable either/both earlier cash conversion of trade receivables similarly to conventional factoring or/and later payment of trade payables. We’ll use a practical example to illustrate the range of structures.

Let’s assume that standard payment terms for goods or services are 60 days in a given industry and that goods or services are delivered on day 0. The customer acknowledges the invoice, say on day 10, confirming that he will not dispute delivery and will pay the invoiced amount. The acceptance of the invoice allows a bank to advance payment to the supplier on day 10. If the customer then paid the bank (and not the supplier) in line with “normal” payment terms, say on day 60, reverse factoring would look identical to conventional factoring. However, in a critical second step, reverse factoring enables later payment by the customer by extending its payment terms to the bank (not the supplier) say to 120 days from 60 days. The supplier is indifferent because it is being paid on day 10 by the bank in any case, but by stretching the due date, the customer is able to extend its payables beyond the standard commercial terms. The funding gap so created through an extension of payment terms and an earlier cash conversion for receivables is funded by a financial institution. And even though this is a date-certain payment obligation to a bank, current accounting standards allow the liability to be reported as trade or other creditors rather than as bank debt.

It is also important to clarify that reverse factoring is not about stretching the terms for an existing invoice beyond what was originally agreed. Rather this is about all parties agreeing longer formal payment terms at the outset, on the understanding that the supplier will actually receive payment at a much earlier date. Under reverse factoring, as illustrated in the example above, the payment terms are often stretched such that supplier gets paid early (day 10) and the customer pays later (day 120). The appeal to the customer is further enhanced by limited disclosure requirements: the liability is typically not reported within financial debt on the balance sheet but is aggregated within trade or other creditors.

A key difference between conventional factoring and reverse factoring is that in the latter credit risk is concentrated around the single customer, which is the sole source of repayments to the bank and also the party who launched and sponsored the reverse factoring facility. By contrast, a conventional factoring facility is requested by the supplier and depends on the credit quality of multiple customers, which delivers a portfolio effect. The greater risk concentration with reverse factoring increases the likelihood that the facility may be curtailed if the sponsoring customer suffers material credit stress. Therefore, reverse factoring is safest when it is used by very strongly rated customers. On the other hand, the risks associated with reverse factoring can become higher when the customer’s own credit quality is less strong and overdependence on reverse factoring can create a critical vulnerability if the customer cannot reliably withstand cancellation of the reverse factoring facility.

Appendix 2 – Accounting for Factoring

Conventional factoring

Conventional factoring typically involves the sale of trade receivables (at a discount) to a bank or other financial institution in exchange for the rights to collect cash from those receivables. Some factoring arrangements transfer substantially all the risk and rewards of the receivables, resulting in an accounting derecognition by the seller, whereas others do not. This derecognition analysis can be complex but in general terms receivables are derecognised when factoring is agreed on a non-recourse basis. In this case, from an accounting entry perspective, the cash raised under the agreement is debited against a derecognition of receivables and no financial liability is recognised. Despite the revolving nature of such agreements and their inclusion in the calculation of aggregate corporate exposure limits by lenders, non-recourse factoring of receivables is not accounted as financial debt. On the contrary when factoring is agreed on a recourse basis, there is no derecognition of receivables and the cash raised under the agreement is debited against a financial liability to the factoring company.

Reverse factoring

As mentioned above, one of the appeals of reverse factoring is the limited disclosure requirements under current reporting standards. Although these arrangements generate a date-certain payment obligation to a bank, under current accounting standards such liability is reported as trade or other creditors rather than as bank debt. This is because under IFRS standards a financial liability, (i.e., a liability to a bank generated by a reverse factoring line) is presented as a trade payable when it represents a liability to pay for goods or services, is invoiced or formally agreed with the suppliers and is part of the working capital. As these conditions can be easily met under reverse factoring agreements, the liabilities generated by such arrangements are generally reported as trade or other payables, but not as a financial liability. Under IFRS standards liabilities that are part of a reverse factoring arrangement should be presented separately if additional security is provided as part of the arrangement that would not be provided without the arrangement and if the terms of liabilities that are part of the arrangement are substantially different from the terms of the entity's trade payables that are not part of the arrangement. Although the latter appears to be true for most reverse factoring arrangements which stretch payment terms beyond standard terms, regrettably this is rarely implemented.

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