Do Accounting Requirements Constrict Supply Chain Finance?

ManMohan S. Sodhi

Preetinder S. Dalla

Cass Business School, City University London

1st Feb 2012

Although supply chain finance appears to offer a win-win-win proposition for buyers, suppliers and banks, buyers have been reluctant to adopt these solutions. It has been suggested that accounting requirements on supply chain finance render its adoption unattractive for buyers through reclassification of accounts payable to debt, thus increasing the debt held by the buyer on their balance sheet.

To investigate whether this is indeed the case, we carried out preliminary research through interviews with four financial organisations; three of the Big 4 auditing firms, one large FTSE 100 retailer, one large FTSE 100 manufacturer and two large corporations about whether accounting implications hinder adoption of supply chain finance and how these organisations are dealing with accounting issues currently. The same interview protocol was used in all cases, with the questions being adapted as required to the type of organisation.

It appears that while reclassification of trade payables to debt may be somewhat of a hindrance in the adoption of supply chain finance by a buying organisation, the reality is more complex. Banks and other financial institutions believe that reclassification is a roadblock and is unnecessary as they are only acting on behalf of the buying organisation to handle payments to suppliers. Also, buyers believe they are only doing this to help their small-and-medium enterprise suppliers and should not invite reclassification. Banks and buyers look to accounting firms, but these firms do not believe there is clear guidance either way on such re-classification and believe that puts them in an awkward situation of interpreting supply chain finance on a case-by-case basis when auditing the buyers.

Three further issues contribute to the uncertainty around reclassification: supplier default, credit notes, and continuity of the availability of credit to the supplier through supply chain finance.

Although further work is needed to find out the reasons, whether or not context dependent, behind the adoption of supply chain finance, it is amply clear that accounting guidelines contribute mainly by absence of qualitative guidance on distinguishing between trade payables and debt when it comes to supply chain finance.

1. Absence of Clear Guidance from the IFRS

Although the idea of supply chain finance became more attractive since the financial crisis in 2008, there is a lack of guidance around reclassification. Banks and buyers prefer that trade payables not be reclassified as debt on grounds that supply chain finance is simply to help out suppliers but accounting firms have been unable to secure adequate clarity on reclassification.

1.1 Banks' Perspective

In supply chain finance arrangements, cash and trade integration technique allows banks to manage and calculate risk properly as long as buyer and supplier are happy with the supply chain's finance requirement of sharing information with each other. Thus, the bank's primary requirement is the information about credit ratings, account payables and receivables of buyer and supplier respectively. According to banks, buying firms are much more aware about the issue, however it is part of their initial process to confirm with buying firms about the accounting implications.

According to a major US-based bank, *"There is no resistance towards accepting the supply chain finance but it slows down the process and seems to be an inhibition among the clients in the start but when they get familiar with the benefit they are fine with it."*

According to financial institutions, some factoring houses provide funding to the supplier on the behalf of the buyer, considering the buyers creditworthiness without any legal settlement with the buyer. This would allow the buyer to obtain off-balance sheet facility as the funds remain immaterial to the buyer's financial statement. A large Japan-based institution feels, "*Since we are paying early on behalf of the buyer, there are no purchase documents, lender consents, legal issues, etc. associated with a receivable purchase. The funding amounts are generally immaterial to the buyer's financial statement, so accounting is not an issue.*"

1.2 Buying Organisations' Perspective

Buying firms are much more aware about the accounting implications arising in supply chain finance arrangements. Buyers explained that extension of payment terms shouldn't cause reclassification of trade creditors into borrowing because payment extension is a clear commercial negotiation between buyer and supplier. Moreover, Supply chain finance is a supplier's choice instead. Buyers are keen towards supply chain finance because it reduces the supply chain risk and strengthens buyer and supplier relationship. Indeed, according to one major UK high-street retailer, "*The joy of this type of process, you give benefits to suppliers while giving them control of themselves and we don't dictate it."*

1.3 Auditors' Perspective

According to auditing firms, IFRS suggests reclassification of trade payables into borrowings *only if there is a substantial difference in the terms of the existing financial liability and the new liability*. Auditors argued that these are very judgemental questions and IFRSs guidance is less prescriptive for the measurement of such financial instruments. According to a director at a Big 4 accounting firm, " *If the exchange between existing borrower and lender is substantially different but it doesn't define what is substantially different. With reference to IAS39,paragraph AG62, terms are substantially different if the discounted present value of cash flows is at least 10% different from the present value of remaining cash flows of original debt. It doesn't give any guidance and debate around that whether you need to look at quantitative question or qualitative matters."*

2. Contributing Risks for Reclassification

2.1 Handling Supplier Default

In pre-shipment supply chain finance arrangements, banks still bear the risk of supplier default. Pre-shipment offerings are based on purchasing orders instead of confirmed invoices; however such arrangements are not attractive.

2.2 Dealing with Credit Notes and Returns

In case of damaged goods or incomplete supplies of goods, the supplier issues credit notes to the buyer. However, auditors raised an issue that buyer's trade payables may not be able to offset the credit notes under supply chain finance programmes. We found that few companies have solved this problem by retaining some amount of the payables to offset credit notes by considering previous rejections of supplier's goods.

Buyers are more concerned about managing credit notes under supply chain finance solutions. Some of the buyers in automotive industry believe that handling of credit notes would be complex in supply chain finance solutions thereby some buyers avoid to take benefits such as rebate sharing and extension of payment terms. One of the buyer suggest that credit notes presentation may give rise to the reclassification of trade creditors as it would require a legal settlement with the bank while another buyer argued that dealing with credit notes is not problem. Buyer utilises the retention model where buyer retains 0-20% of payables to offset the credit notes.

2.3 Supplier Concerns on Credit Availability

Essentially, the supplier remains unsure about the credit availability. An agreement between buyer and supplier that ensures credit availability to the supplier for a certain period would transfer trade payables into financial liability towards the buyers. The buyer avoids such guarantees of credit availability because it can hinder supplier-buyer relationship in case of bank's withdrawal from the SCF program.

Suppliers are nervous that the funding bank or the buyer may withdraw the funding for a *buyer-driven receivable programme* (BDRP) at short notice – thus leaving the supplier in a pickle. If the buyer guarantees that the BDRP will be available for a minimum period it seems that this risks re-classification of trade creditors as debt.

3. Conclusion

To avoid the risk of reclassification of trade payables, supply chain finance mechanism has taken a variety of complex forms. Such complex forms have re-balanced the counterpart risk among all three parties and increased the number of transactions and legal agreements. There are no hard rules because of mixing the concept of materiality and considering the legal aspect of it. IFRS guidance on supply chain finance is required to clarify circumstances that could trigger reclassification of trade payables into borrowings.

Supply chain finance can play an important role for the stability of SMEs especially in the economic recession period. The government should step forward to overcome the challenges in supply chain finance markets. IFRSs are not clear on supply chain finance arrangements. There should be an accounting guidance that clarifies the circumstances of reclassification of trade payables into borrowings. Still, further research is needed on the context of the different perspectives on supply chain finance.

*   *   *