



**PAYABLES FINANCE TECHNIQUE**  
Market Practices  
In Supply Chain Finance



## **Payables Finance Technique** | Market Practices in Supply Chain Finance

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- BAFT (Bankers Association for Finance & Trade)
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- Factors Chain International (FCI)
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- International Trade and Forfeiting Association (ITFA)

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This document represents the collective views of both the BAFT Supply Chain Finance Committee and the Global Supply Chain Finance Forum. This document is intended to provide our members a set of common market practices for Receivables Discounting. Members are encouraged to consult their own internal and external subject matter, legal, accounting and professional advisors to establish internal policies and procedures.

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## Introduction

In 2016, the Global Supply Chain Finance Forum (GSCFF)<sup>1</sup> published the *Standard Definitions for Techniques of Supply Chain Finance (SDTSCF)*<sup>2</sup> in order to outline and establish common market practice guidelines. Supply Chain Finance (SCF) was defined as follows:

**“the use of financing and risk mitigation practices and techniques to optimise the management of the working capital and liquidity invested in supply chain processes and transactions. SCF is typically applied to open account trade and is triggered by supply chain events. Visibility of underlying trade flows by the finance provider(s) is a necessary component of such financing arrangements which can be enabled by a technology platform.”**

The SDTSCF separated SCF into three categories: *Receivables Purchase*, *Loan or Advance-based* and *Enabling Framework*. Within the *Receivables Purchase* category, four techniques were identified:

- Receivables Discounting
- Payables Finance<sup>3</sup>
- Forfaiting
- Factoring

The first of a series of guides focusing on the individual *Receivables Purchase* techniques was published 19<sup>th</sup> June 2019 by the GSCFF, titled *Market Practices and Techniques in Receivables Discounting*.<sup>4</sup> This guide is the second in the series and is meant to complement the aforementioned publications.

This guidance is intended to benefit Finance Providers, Corporate/Commercial/SME clients, Investors, Regulators, Legal Practitioners, Accountants and Standards Bodies and other communities by clarifying common, accepted and emerging market practices in the risk management, documentation, and operational handling for Payables Finance transactions as defined in the SDTSCF. The scope of this guide is limited to the mechanics of the technique rather than how it is administered or executed.

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<sup>1</sup> Global SCF Forum participating organisations: The International Chamber of Commerce (ICC) Banking Commission , BAFT, the Euro Banking Association (EBA), Factors Chain International (FCI), and the International Trade and Forfaiting Association (ITFA).

<sup>2</sup> Standard Definitions for Techniques of Supply Chain Finance; <https://cdn.iccwbo.org/content/uploads/sites/3/2017/01/ICC-Standard-Definitions-for-Techniques-of-Supply-Chain-Finance-Global-SCF-Forum-2016.pdf>

<sup>3</sup> Also known as Approved Payables Finance, Reverse Factoring, Confirming, Confirmed Payables, Seller Payments, Vendor Pre-Pay, Trade Payables Management, Buyer-Led Supply Chain Finance, Seller Finance, or just Supply Chain Finance (the latter two when inappropriately applied as an individual ‘technique’ rather than a holistic category) in the SDTSCF.

<sup>4</sup> <http://supplychainfinanceforum.org/GSCFF-Receivables-Discounting-Common-Practices.pdf>

# Payables Finance

## Definition

Payables Finance is provided through a buyer-led program within which sellers in the buyer's supply chain are able to access finance by means of receivables purchase. The technique provides a seller of goods or services with the option of receiving the discounted value of receivables (represented by outstanding invoices) prior to their actual due date and typically at a financing cost aligned with the credit risk of the buyer. The payable continues to be owed by the buyer until its due date.<sup>5</sup>

In all cases for this technique, the invoices have been approved for payment by the buyer.

## Benefits

Properly structured, and utilised as intended, Payables Finance Programs are intended to provide benefits to buyers and suppliers, with a view to fostering the financial health of supply chains, and enabling domestic and cross-border pursuit of commercial opportunities.

For Buyers, benefits of Payables Finance may include:

- Improved commercial relationships
- Greater supply chain stability and sustainability
- Improved operating processes through automation
- Improved working capital availability

For Sellers, benefits may include:

- Improved working capital
- Improved cash flow forecasting
- Improved flexibility, including the option to finance (or not)
- Access to funding, typically with a lower implied cost than would have been obtained on their own (e.g. bank facilities, traditional factoring).
- Reduced use of credit facilities from traditional banking sources.
- Ability to manage payment risk
- Opportunity to establish and develop new bank relationships (especially for SMEs)

Finance Providers benefit from financing transaction-based, short-term (< 360 days) receivables based on the credit quality of a Buyer and supporting the business objectives of both trading parties. Typically the financing is 'without recourse' to the Seller as relates to credit risk of non-payment by the Buyer. It is, however, common that certain elements of recourse are retained against the Seller by the Finance Provider, such as breaches of representations and warranties as to the quality of the purchased receivable or reductions to the amount of such receivable.

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<sup>5</sup> see footnote 2.

## Mechanics of the Technique

The mechanics described herein cover “without Recourse” programs as they are most common for this structure.<sup>6</sup> These programs:

- may cover the sale of existing and identifiable receivables for goods or services provided to, and accepted by, the Buyer
- are typically unsecured, uncommitted facilities against the Buyer of the goods or services
- are typically for financing trade transacted on an “Open Account” basis
- may apply in the context of both cross-border trade and domestic commerce

The Buyer, acting as the “Anchor Party” establishes a Payables Finance programme with one or more Finance Providers for the benefit of its (designated) participating Sellers. Whilst Payables Finance is often arranged by large corporate Buyers and a Finance Provider of their choice, it can also be established by and for non-investment grade Buyers or arranged with third parties. Payables Finance programs can be domestic or cross-border. Programs are typically contracted under, but not restricted to, United States,<sup>7</sup> English or the preferred governing law of the Finance Provider – which may take into consideration the Buyer’s jurisdiction. Jurisdiction-specific legal nuances apply.

The Buyer and Finance Provider typically enter into a “Buyer Agreement” in which the Buyer identifies invoice(s) or account(s) payable (on its books) for which it confirms an unconditional, irrevocable commitment to pay a specific Seller on a specified date. The Buyer Agreement also serves to mitigate non-credit risks (e.g. performance risk, legal risk) while maintaining the economic substance of the commercial agreement between the Buyer and the Seller.

Sellers electing to participate in the program enter into a separate agreement with the Finance Provider, outlining the terms on which they will receive the discounted value of selected receivable(s) in exchange for selling those receivable(s) to the Finance Provider. The Finance Provider’s objective is usually to purchase the receivable(s) on a “True Sale”<sup>8</sup> basis with that purchase being perfected against the Seller (including its insolvency estate), third party creditors of the Seller (including other assignees) and the Buyer (jurisdiction-permitting).

The Buyer submits payment instructions for approved invoices to the Finance Provider who subsequently notifies the Sellers of the approved invoice(s) available for financing/discounting. The Seller may be given the option to offer to sell the receivable(s) evidenced by those invoices and receive an early, discounted payment from the Finance Provider.<sup>9</sup> Some Finance Providers will structure Payables Finance Programs in a manner that assures participating Sellers of confidentiality about whether/which invoices they seek to discount. This practice is seen to protect Sellers from the exercise of market power by Buyers.

Should the Finance Provider choose not to accept a Seller’s offer,<sup>10</sup> or should a Seller decide against early payment, the Seller will be paid the full value of the approved invoice on its due date.<sup>11</sup> Regardless of a Seller’s decision, the Buyer is expected to pay the principal amount owed on the approved invoice maturity date to the Finance Provider who will receive those monies either for its own account (where it has discounted the

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<sup>6</sup> Refer to the *Standard Definitions for Techniques of Supply Chain Finance* for definitions of terms

<sup>7</sup> U.S. agreements are contracted under state law, most commonly New York.

<sup>8</sup> The concept of ‘true sale’ is discussed in more detail in a separate chapter of this document

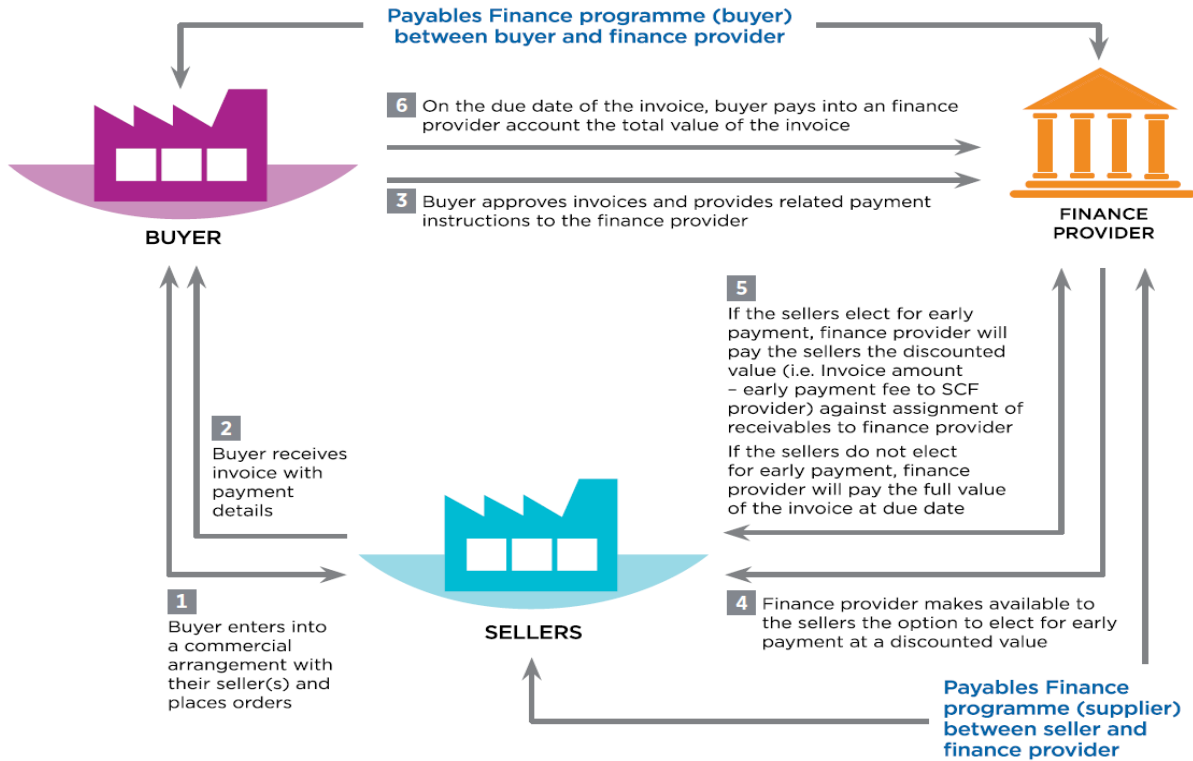
<sup>9</sup> A less common variation is to finance a portion of the invoice (i.e. partial financing). Not available in all jurisdictions; Additional risks may apply.

<sup>10</sup> For avoidance of doubt, the Finance Provider has no obligation to finance

<sup>11</sup> Also known as “net date”; Payment could come from either the Finance Provider or Buyer.

receivable(s)) or to pay on to the Seller (where it has not discounted). The party (Seller or Finance Provider) that owns the receivable at invoice maturity bears the risk of Buyer late payment or non-payment. Refer to Figure 1: Payables Finance Schematic.

**Figure 1: Payables Finance Schematic**



Source: Global SCF Forum

Where the Finance Provider has purchased the receivable(s), any dilutions, commercial disputes or other adjustments (e.g. for damaged goods) between the Buyer and Seller would be resolved outside of the Payables Finance structure. The Finance Provider may provide tools to support that process (e.g. applying claims to undiscounted invoices), subject to:

- the individual agreement between the finance provider and the buyer, and
- external factors such as the jurisdiction(s) of the program.

Exceeding the intended scope of this guide, two topics warrant brief mention: the secondary market for Payables Finance assets and the impact of technology on the evolution of the industry.

Purchased receivables, and the associated risks, may be held by the Finance Provider or distributed to third parties in a variety of forms (e.g. insurance, assignment, participation, notes, funds, etc.).

Evolving secondary market practices coupled with increasing numbers of providers and investors interested in SCF have enabled broader access, larger programs and improved liquidity.

Technology-fueled increases in scale, efficiencies and experiences have accelerated the growth rate and market access to Payables Finance. The effect is that the barriers to entry have been reduced for all market

participants (i.e. Finance Providers, Buyers, Sellers and Investors). These developments have enabled the and growing adoption of Payables Finance by micro, small and medium enterprises (MSMEs). Development banks and multilateral organisations expect Payables Finance to be an increasingly effective solution to the approximately USD 1.5 trillion shortfall in MSME trade financing.<sup>12</sup>

## Legal Agreements and Documentation

Generally, there are two types<sup>13</sup> of legal agreements executed by the Finance Provider of a Payables Finance program:

- (1) A “Buyer Service Agreement” with the Buyer
- (2) A “Receivables Purchase Agreement” (RPA) with each participating Seller

### Key Buyer Agreement Provisions

The Buyer Agreement defines the terms of the program under which the Buyer submits invoices or accounts payable to the Finance Provider for which it gives an unconditional, irrevocable payment obligation to the Finance Provider to pay in full any invoice it accepts on the relevant due date without set-off, dispute or counter-claim.<sup>14</sup>

The Buyer Agreement will support the intended balance sheet outcome discussed and agreed between the Buyer and its accountant and typically contains the following:

- Buyer’s request and authorization for the Finance Provider to provide payment services, specifically the payment amount, payment due date, invoice number and other information required for each submitted invoice
- An unconditional, irrevocable payment obligation without set-off, dispute or counterclaim
- Acknowledgement of Finance Provider’s right to purchase/assign receivables and the corresponding process for perfecting a purchase against the Buyer and third party creditors of the Seller
- Terms governing the exchange of information to be provided (e.g. invoices, credit notes, etc.) via platform, email or other means
- Governing law and jurisdiction
- Jurisdiction-specific requirements (e.g. regulatory, tax, etc.)
- Right of set-off for non-payment
- A waiver of any restrictions on the Seller’s ability to assign/sell/transfer invoices (for goods and services provided to Buyer)
- Other (e.g. indemnifications, obligation of the Buyer to notify the Finance Provider of known adverse claims, termination, confidentiality, data privacy, etc.)

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<sup>12</sup> International Finance Corporation SME Finance Forum. (2019). [online] Available at: <https://www.smefinanceforum.org/data-sites/msme-finance-gap>

<sup>13</sup> In some jurisdictions and circumstances a third type of agreement or ownership agreement on receivables may be required, subject to legal analysis in the particular jurisdiction.

<sup>14</sup> A variation is for the irrevocable payment authorisation to be triggered only if the invoice is purchased by the Finance Provider



## Key Receivables Purchase Agreement (RPA) Provisions

An RPA defines the terms under which the Seller provides an assignment of rights to the receivables being financed by the Finance Provider. RPAs must be structured according to the requirements of the jurisdiction in which they shall be applied.

The RPA typically contains the following provisions:

- Treatment as a “True Sale” from Seller to Finance Provider, meaning the Finance Provider has an unqualified right (vs. only a lien) over the receivable, where applicable and jurisdiction-permitting
- Sale and purchase provisions and confirmation that the sale and purchase is intended to constitute a True Sale
- Definition of eligible receivables, exclusions for receivables subject to dilutions or dispute
- De-recognition of assigned receivables from the Seller’s balance sheet, and
- Terms governing the exchange of information (e.g. invoices, credit notes, notices of assignment, etc.)
- Purchase date, price and mechanics (e.g. reference rate & spread, automatic or manual discount, etc.)
- Receivables representations, warranties and undertakings (e.g. Seller owns receivables, receivables criteria, etc.)
- Authorisation for Finance Provider to perfect its rights arising from the RPA (e.g. provide notice of assignment, file with a central registry)
- Governing law and jurisdiction
- Jurisdiction-specific requirements (e.g. regulatory, tax, etc.)
- Asset trading clause/ assignment (i.e. Finance Provider’s ability to assign purchased receivables to third parties)
- Repurchase events (usually limited to breach of receivables representations and warranties as to the quality of the receivables, fraud and commercial disputes)
- Other (e.g. indemnifications, termination, confidentiality, data privacy, etc.)

## True Sale Intent

Although a detailed review of “True Sale” is outside the scope of this paper, it is a critical structuring component of the Payables Finance technique that aims to exclude purchased receivables from the Seller’s bankruptcy or insolvency estate and/or allow the Seller to derecognize purchased receivables from its financial statements.

Legal tests for “True Sale” are complex and vary by jurisdiction. For example, US courts will consider the parties’ “substantive intent”<sup>15</sup> and the economic substance<sup>16</sup> of the agreement (e.g. level of recourse to the Seller, degree to which risks and rewards are transferred, control of the asset). In England, form will normally win over substance subject to the agreement not being a sham. Common practice is to bolster the characteristics of a sale contained in an RPA in an attempt to lower the risk that a court would view it as a secured loan. Bankruptcy court rulings vary widely for True Sale, subject to jurisdiction.

For the purpose of achieving true sale, Payables Finance RPAs are generally without recourse or with limited Recourse to the Seller. A generally acceptable exception is to include warranties of quality, validity and enforceability, breach of which triggers either “repurchase events” that require the Seller to repurchase specific invoices within a stipulated period of time, or indemnities. Repurchase events or indemnities may be triggered by any of (but not limited to) the following:

- A receivable being or becoming ineligible – either because it was never eligible in the first instance, or, as a result of events post-discounting.
- Disqualifying events, such as fraud or judicial actions that may occur after the Finance Provider has purchased the receivable and which relate to a breach or fault of the Seller.
- Failure to perform or observe any other term, covenant or agreement with respect to any of the purchased receivables and such failure having a material adverse impact.

## Perfection

In addition to making every effort to ensure “True Sale” treatment, best practice is to take jurisdiction-appropriate steps to “perfect” (i.e. prioritise relative to the claims of third parties including creditors of the Seller and any officials appointed to run the Seller on an insolvency) ownership interest in the purchased receivable. Perfection is also an effective mitigant against double assignment in many jurisdictions.

With some exceptions, priority can be achieved by having the first assignment in time in some jurisdictions, or by being first to notify the debtor in other jurisdictions. Additional steps (e.g. confirmation of receipt of the notice by the Buyer, filing with a central registry in the Seller’s jurisdiction) may also be required depending on several factors, including:

- Residency or jurisdiction of incorporation of the Finance Provider, Buyer and Seller
- Governing law of the underlying commercial contract and the RPA
- Whether the receivables in question have been previously pledged or registered

In the case of pledged receivables, pledgee consent (e.g. inter-creditor agreement) is typically required for valid assignment but legal standards are often nuanced and may vary by jurisdiction.

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<sup>15</sup> Refer to precedent case *Granite Partners, L.P. v. Bear, Stearns & Co., Inc.*, 17 F. Supp. 2d 275 (S.D.N.Y. 1998)

<sup>16</sup> Refer to precedent case *Endico Potatoes, Inc. v. CIT Group/Factoring, Inc.*, 67 F.3d 1063 (2d Cir. 199, 5).

## Selected Risks and Mitigants

Liabilities arising from SCF programs do not create additional financial risk above and beyond those that arise from trade between a buyer and a seller or any other credit product. The Payables Finance technique is subject to a variety of risks, the most fundamental of which is Buyer credit risk. Deteriorating Buyer credit quality affects each participant as follows:

- Finance Providers: Credit losses from default; reputational damage
- Sellers: Escalating discount rate and possible loss of discount opportunities
- Buyers: Deterioration of relationships with the Seller and Finance Provider which may lead to supply chain disruptions

Additional risks and common mitigants are listed below. Mitigants identified by audit firms<sup>17</sup> that may jeopardise trade payables treatment on the Buyer’s balance sheet are listed as “non-standard”.

Risks	Mitigants
Buyer Credit Risk	<ul style="list-style-type: none"> <li>• Finance Provider’s KYC, risk assessment and monitoring on the Buyer</li> <li>• Finance Provider’s internal credit limits on the Buyer</li> <li>• Uncommitted nature of the facility</li> <li>• Credit risk distribution (e.g. insurance, investors)</li> <li>• Contractual protections (e.g. right of set-off)</li> <li>• Non-standard: collateral, third-party guarantee, broad recourse to Seller and cross-default</li> </ul>
Operational risks <ul style="list-style-type: none"> <li>• Seller onboarding</li> <li>• Inefficient or errant invoice approval processes</li> </ul>	<ul style="list-style-type: none"> <li>• Dedicated and customized seller onboarding program</li> <li>• Robust processes, automation, controls</li> <li>• Automated invoicing processes (e.g. e-Invoicing)</li> </ul>
Enforcing Rights in Foreign Countries: <ul style="list-style-type: none"> <li>• Enforceability of irrevocable payment obligation</li> <li>• Enforceability and characterization of sale and purchase / assignment</li> <li>• Conflicts of laws</li> <li>• Uncertainty from inadequate case law / precedent cases</li> <li>• Service of process</li> </ul>	<ul style="list-style-type: none"> <li>• Detailed jurisdictional due diligence</li> <li>• Notice / filing protocols, as applicable</li> <li>• Mandating a named Process Agent for participants outside the home market(s) of the Finance Provider</li> <li>• Contractual protections (e.g. governing law, jurisdiction)</li> <li>• Negotiable instruments</li> </ul>
Dilution Risk / Commercial Disputes	<ul style="list-style-type: none"> <li>• Contractual exclusion</li> <li>• Re-purchase events/indemnities<sup>18</sup></li> </ul>
Double Assignment Risk <ul style="list-style-type: none"> <li>• Fraud</li> <li>• Process errors</li> <li>• Lack of corporate or signing</li> </ul>	<ul style="list-style-type: none"> <li>• Appropriate diligence on all participants</li> <li>• Perfection of assignment of the receivable against Buyer, creditors/pledgees and bankruptcy trustees</li> <li>• Possession and proper endorsement of a negotiable</li> </ul>

<sup>17</sup> Non-exhaustive; includes only content freely available in the public domain

<sup>18</sup> Refer to “True Sale Intent” section

officer authority	instrument as per relevant jurisdictional requirements
Seller Insolvency	<ul style="list-style-type: none"> <li>• Appropriate due diligence on all parties</li> <li>• Perfection of assignment of the receivable against Buyer, creditors/pledgees and bankruptcy trustees</li> </ul>

All the above risks are also mitigated by a robust monitoring, reporting and audit processes regarding transactions, systems and controls.

## Market Practices for Payables Finance-Specific Issues

Although not required by the standard definition of Payables Finance, there are several common market practices and variations worth briefly reviewing. In addition to those practices listed below, the following are applicable to Payables Finance but excluded from this Paper because they were adequately covered in the Receivables Discounting Techniques Paper<sup>19</sup>:

- Unbilled receivables
- Trade Credit Insurance
- Audit confirmation
- Syndications and participations

## Negotiable Instruments

The discounting of a Negotiable Instrument<sup>20</sup> that is payable on demand or at a future date is a well-established practice. It is not uncommon for Finance Providers to also utilise it programmatically to facilitate Payables Finance programs. Depending on the objectives and purview of the Finance Provider, this practice may be exercised for risk mitigation (e.g. ownership perfection ) or program scalability (e.g. substitute for RPA). Usage of Negotiable Instruments may impact the accounting treatment of the Payables Finance program and should be subject to an individual analysis by an accountant.

## Digitisation

It is the view of the GSCFF that the underlying practices of the Payables Finance technique are agnostic to the method by which they are actually performed (e.g. paper vs. electronic<sup>21</sup>). Whereas digitisation methods have demonstrated varying degrees of value in domains such as risk mitigation and efficient processing, the Payables Finance technique can be exercised in their absence or in combination with digitisation techniques.

<sup>19</sup> Refer to footnote 4 for a link to the *Market Practices and Techniques in Receivables Discounting* paper

<sup>20</sup> Common examples being bills of exchange, drafts and promissory notes

<sup>21</sup> Negotiable Instruments are a notable exception

## Self-Liquidating Capital Treatment

As discussed in the definition, Payables Finance is connected to the exchange of goods and/or services as it is used to finance the goods and/or services sold by a seller to a buyer based on an underlying commercial contract between the seller and the buyer. Hence, it can be properly described as a trade finance technique.

The Finance Provider does not offer the product to provide ongoing financing to the trading parties, because it is at the finance provider's own discretion whether to purchase an invoice or not. Hence, there is no commitment for the finance provider to purchase the invoice, i.e. to finance the seller.

In a Payables Finance structure, the buyer either:

- directly sells the purchased goods and/or services to a third party (direct onward sale), or
- uses the purchased goods and/or services to create additional value from the goods and/or services as part of its core business activity, and subsequently sells them onward to a third party (indirect onward sale).

Since the transactions are short-term and the maturity is typically well below one year, the financing technique can be categorized as self-liquidating.

## Accounting Treatment

### Note from the Authors

This section is not intended to provide any authoritative guidance, which can only result from an individual analysis of a company, its specific environment and subsequent advice from its accountant. The intention is rather to highlight common critical aspects of accounting treatment that – as the authors of this document understand it – apply to any Payables Finance program. It is expected that the contractual arrangements and circumstances of negotiation between the Buyer, the Seller and the Finance Provider will be relevant in this context. Without providing any specific guidance or direction, this section shall raise the awareness of the reader regarding which elements of these contractual arrangements may be relevant from an accounting perspective.

Individual parameters (e.g. the particular industry, the company size, the region, the applied accounting standard and the local regulator overseeing the contractual setup) are drivers for the need for obtaining specific accounting advice at the company level.

No specific accounting guidance (IFRS<sup>22</sup> or U.S. GAAP) exists for structured trade payables arrangements. “The lack of detailed accounting rules for distinguishing when an account payable is considered ‘commercial’ or financial debt under SCF agreements leaves corporations as well as investors and analysts to grapple with a diversity of practice.”<sup>23</sup> This reality can also lead to abuse of Payables Finance programs, and in so doing, may dilute their efficacy and potential in helping to address demand for trade financing, particularly among SME Sellers and Suppliers.

In order to address the current shortcomings, the IFRS Interpretations Committee has taken the corporate balance sheet classification and disclosure of Payables Finance programs on their agenda. Results are expected to be available by end of 2020. The IFRS Interpretations Committee has published an intermediary report on their discussion and findings.<sup>24</sup>

The uncertainty surrounding the accounting treatment and reporting requirements of Payables Finance structures have been widely identified as potential barriers to adoption.

The primary challenge is Buyer uncertainty as to whether the classification of its trade payables should continue unchanged or if a Payables Finance program causes its trade payables to be extinguished and replaced by a different liability (most notably, bank debt). Such re-classification is usually not favorable because it may increase the company’s leverage, which may affect financial covenants, ratios and disclosures.

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<sup>22</sup> Refers generically to standards released under both IASB as well as IASC, its predecessor

<sup>23</sup> EY. (2017). *Supply Chain Finance: Companies pursuing an economic advantage sometimes find themselves in a complex accounting territory*. [online] Available at: <https://www.ey.com/es/es/home/ey-supply-chain-finance-companies-pursuing-an-economic-advantage-sometimes-find-themselves-in-opaque-accounting-territory>

<sup>24</sup> <https://www.ifrs.org/projects/work-plan/supply-chain-financing-arrangements-reverse-factoring/comment-letters/projects/tentative-agenda-decision-and-comment-letters/>

If a Buyer borrows to settle its trade payables, this will be reflected as bank debt. However, if the same Buyer develops a Payables Finance program for its Sellers, the trade payables may remain as trade payables on its balance sheet, provided certain specific but still evolving criteria are met.

Whether trade payables in Payables Finance programs should be re-classified is “judgmental and not directly addressed in U.S. GAAP. The principles applied when analysing such arrangements are based on financial instrument derecognition guidance and past SEC staff speeches.”<sup>25</sup>

Guidelines from the U.S. Securities and Exchange Commission (SEC) were taken from comments delivered in 2003<sup>26</sup> and 2004<sup>27</sup>. In summary, transactions should be evaluated on a case-by-case basis and the “economic substance” should be considered.

While there is no exhaustive list of criteria to minimize re-characterisation or clear guidance, it is useful to highlight some key criteria that have been mentioned as relevant in this context:

- There should be no tri-party agreements. Rather there must be separate contractual agreements between the Buyer and the Finance Provider (as its paying agent), as well as between the Sellers that join the program and the Finance Provider making payments to them.
- The agreement between the Buyer and the Finance Provider should not request financing.
- The commercial purpose of the Payables Finance program should be to support the Sellers to the Buyer in obtaining affordable credit.
- The payment terms agreed between the Buyer and its Seller should remain unchanged after establishing a program and/or be in line with industry norms.
- The payment terms should apply across a Buyer’s supplier base, independent of whether a Seller opts into a Payables Finance program or not.
- The Buyer should irrevocably agree with the Finance Provider to pay its obligation on the agreed invoice maturity date.
- The Finance Provider should have no greater surety of being paid for purchased invoices than the Sellers issuing the invoices (e.g. from additional confirmations, obligations or guarantees from the Buyer itself or a third party to be paid).
- The financing conditions under which invoices are to be purchased should be negotiated exclusively between the Finance Provider and the Seller.
- A Seller’s invoice should usually be assigned to a Finance Provider rather than extinguished (e.g. by novation of the invoice).
- The fee or interest pertaining to the purchase of the invoices by the Finance Provider is borne by the Seller.

Whereas auditors’ views can vary by firm, accounting standard and jurisdiction, they invariably agree that assessment is required on a case-by-case basis.

In recent years, rating agencies have begun to place heightened levels of scrutiny on Payables Finance and its accounting practices. In 2015, citing Abengoa<sup>28</sup> as an example, Moody’s reported that reverse factoring<sup>29</sup> had

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<sup>25</sup> PwC. (2017). *Structured payables: Should your trade payables be classified as debt?* [online] Available at: <https://www.pwc.com/us/en/services/audit-assurance/accounting-advisory/structured-payables.html>

<sup>26</sup> <https://www.sec.gov/news/speech/spch121103rjc.htm>

<sup>27</sup> <https://www.sec.gov/news/speech/spch120604rjc.htm>

<sup>28</sup> Abengoa S.A., a multinational infrastructure, energy and water company headquartered in Spain.

<sup>29</sup> A common synonym for Payables Finance; Refer to footnote 3.

debt-like features. Subsequently, through industry advocacy led by the ITFA<sup>30</sup>, Moody's has since updated its stance to a more nuanced view.<sup>31</sup>

In January 2018, concerns resurfaced following the collapse of Carillion.<sup>32</sup> Following these events in October 2018, The International Trade and Forfeiting Association (ITFA) published a report summarizing the considerations required to assess Payables Finance arrangements and calling for increased transparency, as well as greater dialogue between all stakeholders to clarify methodology and best practices. The BAFT Global Trade Industry Council (GTIC) Payables Finance Principles paper is illustrative.<sup>33</sup>

A recent publication from Moody's<sup>34</sup> takes a closer look at how Payables Finance is reflected on a Buyer's balance sheet and suggests specific elements for consideration: of note:

- **Greater Transparency:** Many Buyers are not required to make public their Payables Finance programs, so users of financial statements may not be aware, despite the potential material consequences
- **Extension of Terms:** There is a potential impact of hidden debt-like obligations on financial ratios in the buyer's balance sheet if Payables Finance allows repayment tenors to vary significantly from typical, sector-level commercial terms
- **Impact on Future Liquidity:** Because of the potential size of these Payables Finance programs, the cancellation of such programs could lead to a sudden working capital outflow over a short period of time, leading to a liquidity crunch.<sup>35</sup>

Moody's calls for greater transparency so that the impact of Payables Finance on the Buyers' balance sheets can be more easily assessed and properly evaluated. It is important to note that Moody's does not conclude that Payables Finance is harmful or to be avoided.

While the examples of Payables Finance abuse (e.g. to force a Seller into accepting uncommercial payment terms) are few, they are nevertheless worrying. Such cases have been prominently highlighted, but they are not representative of how Payables Finance programs are used by the majority of Buyers and Sellers in mutually-supportive supply chains. Payables Finance – correctly implemented – continues to be used as a means for Buyers and Sellers to optimise their respective working capital positions, and to strengthen their relationships.

The GSCFF acknowledges the need for Buyers and Sellers to continue to improve their working capital. To support this goal, the GSCFF advocates for the continued use of Payables Finance programs, as they present significant benefits for all stakeholders involved if applied in a reasonable and appropriate manner.

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<sup>30</sup> The International Trade Forfeiting Association

<sup>31</sup> [https://www.moodys.com/research/Moodys-Reverse-factorings-rising-popularity-comes-with-high-but-hidden--PBC\\_1195322](https://www.moodys.com/research/Moodys-Reverse-factorings-rising-popularity-comes-with-high-but-hidden-PBC_1195322)

<sup>32</sup> Carillion plc, a multinational facilities management and construction services company headquartered in the UK

<sup>33</sup> Source required for BAFT GTIC PF Principles paper

<sup>34</sup> See footnote 31.

<sup>35</sup> It should be noted this risk is not different from a any other credit arrangement the buyer may use



## Compliance and AML Requirements

Guidance on KYC, AML and sanctions requirements is adequately covered in separate industry guidance documents, specifically *The Wolfsberg Group, ICC and BAFT Trade Finance Principles (2019 amendment)*<sup>36</sup>

For readers' benefit, a basic summary of Payables Finance due diligence standards for the primary participants is provided here.

### Participant: Buyers - Risk Party

As for any other credit analysis, the required diligence standard on the buyer is full KYC.

Summary:

- Finance Provider “should conduct due diligence as appropriate on Party X (Buyer) that is a customer of (Finance Provider) prior to the setup of a Payables Finance program. This is likely to involve a series of standardised procedures for customer adoption. The due diligence will support an on-going relationship with Party X and is not required for each subsequent program that is set up with this customer.”
- “(Finance Provider) will heavily rely on the initial and ongoing due diligence conducted on Party X. It will not be required for (Finance Provider) to continually seek additional assurances from Party X as every new transaction is received for processing, since it will be subject to the regular transaction monitoring activities of (Finance Provider).”

### Participant: Sellers

Diligence Standard Required: Risk Based Due Diligence

Summary:

- Assuming a finance Provider “has no other relationship with that third party. Such counterparties do not have an account, a facility or a dedicated Relationship Manager at (Finance Provider), and they also do not give any instructions to (Finance Provider). They are sponsored by a global line of business, and interactions with (Finance Provider) are limited to the scope of the Payables Finance program of Party X. The relationship with these counterparties is based on a successful CDD on Party X and the trust of (Finance Provider) in the commercial relationships Party X enters into for the purpose of its own business.
- It is generally recommended to perform risk based checks on counterparties with the local regulatory requirements as the baseline. The extent of such checks may vary depending on the particular SCF technique that is applied. The risk based checks may include (but are not limited to) the following:
  - Counterparty name and address information
  - Sanctions screening against relevant list(s)

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<sup>36</sup> [https://iccwbo.org/publication/wolfsberg-trade-finance-principles/?\\_cldee=ZGF2aWQudHJlY2tldkBiYW5rb2ZhbWVyaWNhLmNvbQ%3d%3d&recipientid=contact-dfca9da0012ee911a9a3000d3ab382ec-ea0c2c6cecee4ae1a1c3705672ba62f2&esid=c6fbc3b0-9049-e911-a98a-000d3ab11b7a](https://iccwbo.org/publication/wolfsberg-trade-finance-principles/?_cldee=ZGF2aWQudHJlY2tldkBiYW5rb2ZhbWVyaWNhLmNvbQ%3d%3d&recipientid=contact-dfca9da0012ee911a9a3000d3ab382ec-ea0c2c6cecee4ae1a1c3705672ba62f2&esid=c6fbc3b0-9049-e911-a98a-000d3ab11b7a)

- Review against internal 'red flag' lists.
- Risk evaluation of the potential relationship of o the counterparty...to identify whether a Finance Provider may require further review based on internal risk tolerance.
- It is important that the checks performed on the counterparty be consistent with the Finance Provider's policies regarding parties for other, similar products (e.g. checks on the beneficiaries of letters of credit issued by the Finance Provider)."

## Disclaimers

This document represents the collective views of the Global Supply Chain Finance Forum (GSCFF). This document is intended to provide GSCFF members, partners and industry participants a set of common market practices for Payables Finance. Readers are encouraged to consult their own internal and external subject matter, legal, accounting and professional advisors as well as compliance specialists and authorities as appropriate, to establish internal policies & procedures.