Contract receivables

What is it and how can it benefit your business?

Contract receivables

The timing of when businesses receive revenues from customers is in the spotlight thanks to IFRS 15. A good financing facility can mitigate the balance sheet impact of the new standard and improve working capital.

IFRS 15 – Revenue from Contracts with Customers, which specifies how a supplier should record all the revenues from the contracts it enters into with its customers, came into effect for the accounting period beginning on or after 1 January 2018.

The new international financial reporting standard is the result of a joint project by the International Accounting Standards Board and the US Financial Accounting Standards Board. Their aim was to promote consistency and comparability in financial reporting by developing a single set of accounting principles that businesses could use to recognise their earnings from customer contracts across all industries and most types of revenue transactions.

Significantly, the new standard distinguishes between the performance obligations under a contract that a business satisfies 'at a point in time' and those that it satisfies 'over time'. As a result, the business must recognise in its reporting the revenue that it earns under the contract as and when it meets its performance obligations. This differs from past practice, when businesses could recognise revenue in even instalments across the period of a contract or recognise all revenue upfront.

IFRS 15 applies to the majority of contracts with customers where a business has ongoing performance obligations that a customer pays for. Examples of such contracts include IT managed service agreements and licencing agreements. The approach to recognising income that is set out under IFRS 15 aligns performance-related contracts with how lease income will be recognised under IFRS 16 – Leases.

IFRS 15 – 5 step model

Under IFRS 15, businesses under contract to provide goods or services to a customer are required to follow a 5 step process to recognise revenue.

Where does contract receivables fit in?

IFRS 15 may have significant balance sheet and P&L implications for businesses since it could significantly delay their ability to recognise and deploy revenue in some cases. One way for them to mitigate this impact of IFRS 15, and improve their working capital position, is by taking advantage of a contract receivables financing solution.

With contract receivables, a business sells to a third-party finance provider the rights to receive the future contracted cash flows for delivered assets and services due under a new or existing contract that it has with one of its customers. The business would sell these rights at a discount, which normally equates to the interest rate that its customer would have to pay on a term loan with a duration that is equivalent to the length of the contract. In exchange, it gets an accelerated contract cash flow that offsets the capital expenditure impact of acquiring or producing the assets and services in the first place, enabling it to re-invest in activities that will further grow its revenues.

Contract receivables should not be confused with a selective receivables solution, which could be used to finance specific invoices over a short-term period. A contract receivables solution is term funding that is matched to the tenor of the underlying contract that a business wants to finance – typically between two and seven years in length.

The benefits of using contract receivables for a business that supplies assets and services to customers include:

- Receiving a payment of the net present value (NPV) of the contract as a cash injection, which could help to improve cash and liquidity ratios and speed up the cash conversion cycle
- Removing long-term receivables from the balance sheet and transferring any credit default risk associated with these contracts
- Taking advantage of bank funding at an attractive rate that may be a more effective way of funding the contract throughout its duration than using internal cost of capital.

Consumers are comfortable with the idea of a service-based contract thanks to the widespread adoption of mobile phones.

Contract receivables as a business opportunity

Thanks to the rise of the asset 'as-a-service' economy, the potential for contract receivables is increasing. Consumers are already very comfortable with the idea of a service-based contract since it is the model most commonly used by the telecommunications companies that supply mobile phones. The concept has also caught on in the business-to-business world, particularly for technology assets that are regularly upgraded or refreshed, or that have a fixed life cycle.

Today, businesses are increasingly innovating to provide new services, which include making assets available on a service basis and extending credit for assets delivered upfront over the course of a contract term. Whenever a business enters into a contract to supply goods and services to a customer, with payment made in instalments over time, that contract is potentially eligible for contract receivables finance.

Contract receivables can be used to finance a wide range of assets and services, from cars and trucks, laptops, IT servers and industrial machinery, through to film rights, the supply of high-performance protective equipment for emergency services teams and even tarmac for out-of-town shopping centres. End users of these kinds of assets and services tend to be comfortable about the idea of their contract with a supplier being sold and assigned to a bank.

An important criterion that analysts and investors use to judge a company's prospects is the health of its cash position. So, by removing long-term receivables from the balance sheet, and boosting its cash and liquidity ratios, a business can increase its ability to attract external investment.

About Barclays Contract Receivables

Barclays has its own Contract Receivables facility, which is suitable for Barclays' corporate clients that supply products and services under contract to end users that are also clients of Barclays. The current minimum contract value for the solution is typically £3m and the term of the contract is usually between two and seven years. While the supplier of the goods and services needs to be a UK entity, the end user can be based in the UK, Europe or the US.

Removing long-term receivables from the balance sheet, and boosting cash and liquidity ratios, can increase external investment potential for a business.

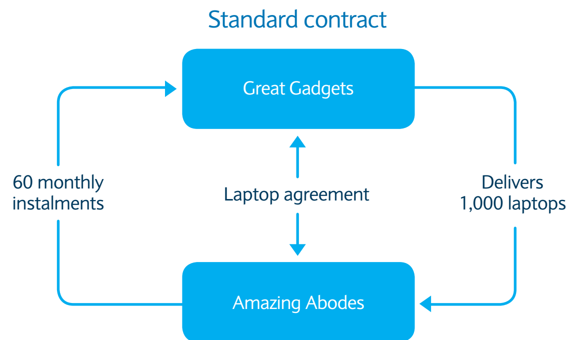
Under the terms of the facility, the supplier sells Barclays the rights to receive future contracted cash flows for assets and services that have already been delivered to the end user. Barclays usually pays the supplier the NPV of the end user's future contracted payment obligations at the outset of the contract. Alternatively, it could stagger the payment so that the supplier receives part of it at the outset of the contract and the rest during the course of the contract term, as specific milestone deliverables are met and accepted.

Before offering a facility, Barclays will thoroughly review the contract documentation and undertake a credit assessment of the contract end user. The credit risk of the end user is one of the factors that will determine the pricing of the facility, along with the performance and sector of the supplier business, any security or guarantee that has been taken, and the amount and tenor of the loan.

How it works in practice

Great Gadgets plc, an IT reseller, has a customer called Amazing Abodes Ltd, which is a nationwide estate agent chain. Amazing Abodes wants to reduce the amount of high-street office space that it rents and get more of its agents working from home. So it enters into a contract with Great Gadgets to buy 1,000 laptops that it will distribute to its agents across the country.

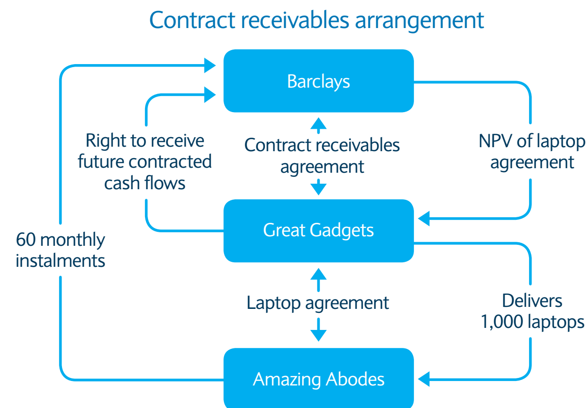
Standard contract



Amazing Abodes is concerned that paying the upfront cost for all the laptops could have a negative impact on its working capital. Fortunately, Great Gadgets will allow Amazing Abodes to pay for the laptops in monthly instalments over the course of five years. The instalments that are due under the contract will only start after Great Gadgets has delivered all of the laptops to Amazing Abodes.

Great Gadgets has ambitious plans to grow its business and wants to recoup its capital investment in the 1,000 laptops that it has sold to Amazing Abodes. So, once it has delivered the laptops to Amazing Abodes, it decides to sell its right to receive the future revenues associated with the contract to Barclays. As a result, the customer agreement with Amazing Abodes is assigned to Barclays so that Barclays receives the monthly payments for the laptops from Amazing Abodes and Great Gadgets is paid the NPV of these payments.

Contract receivables arrangement



Now Great Gadgets can focus on the future with confidence, knowing that it has recouped its capital investment on the laptops, that it can invest in expansion, and has transferred the risk of Amazing Abodes defaulting on its debt to Barclays.

To find out more about how Barclays Contract Receivables can help your business to grow, speak to your Relationship Director.

If you found this article interesting and want to read more of our articles and reports, you can access our Insight & Research pages at: **barclayscorporate.com/insight-and-research.html**

Further reading

To find more detail on IFRS (International Financial Reporting Standards), see: **http://www.ifrs.org**

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