



8 September 2010

To: Members of the Hong Kong Institute of CPAs
All other interested parties

Invitation to Comment on Exposure Draft of Hong Kong Interpretation 5 *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that contains a Repayment on Demand Clause*

Comments to be received by 29 October 2010

The Hong Kong Institute of Certified Public Accountants' (Institute) Financial Reporting Standards Committee (FRSC) is seeking comments on the Institute's Exposure Draft of Hong Kong Interpretation 5 *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that contains a Repayment on Demand Clause* which has been posted on the Institute's website at:

<http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/exposure-drafts/>.

"Term loans" are loans which are repayable on a specified date or in instalments over a period of time, usually in excess of one year. Loan facility agreements for such term loans will set out the basic terms, such as the scheduled re-payment date(s), interest rates and additional charges for early repayment, and may also include specific clauses which define default events which would give the lender the right to accelerate the repayment terms if those events occur.

In addition to defining events of default and the consequences of their occurrence, some term loan agreements include an overriding repayment on demand clause, which gives the lender the right to demand repayment at any time, at their sole discretion and irrespective of whether a default event has occurred. In such cases, the question arises as to whether the term loan should be presented in the statement of financial position in accordance with the scheduled repayment dates, or whether the entire loan should be presented as current, given the lender's overriding right to demand repayment at any time.

The purpose of draft Hong Kong Interpretation 5 is to address this question with reference to the criteria for classification of liabilities as current or non-current as set out in paragraph 69 of HKAS 1, *Presentation of Financial Statements*. In particular, the FRSC noted the requirement of paragraph 69(d) of HKAS 1, which requires an entity to classify a liability as current when "it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period".

The draft Interpretation sets out the FRSC's conclusion that the classification of a term loan as a current or non-current liability in accordance with paragraph 69(d) of HKAS 1 should be

determined by reference to the rights and obligations of the lender and the borrower, as contractually agreed between the two parties. Therefore, in cases where a repayment on demand clause provides the lender with a clear and unambiguous unconditional right to demand repayment at any time at its sole discretion, the entire loan should be classified as current, as the existence of this right means that the borrower does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. The likelihood of the lender exercising this clause may be relevant to certain disclosures required under HKFRS 7, *Financial Instruments: Disclosures*, in respect of the entity's approach to managing its liquidity risk, but it is not a relevant consideration for the classification of the loan in the statement of financial position in accordance with paragraph 69(d) of HKAS 1.

The FRSC intends to issue the draft Interpretation in November 2010 to be effective immediately upon release subject to issues identified during the commentary period on this Exposure Draft.

The FRSC invites comments on the draft Interpretation from any interested party and would like to hear from both those who do agree and those who do not agree with the draft conclusions contained in the draft Interpretation on the application of HKAS 1.

Comments should be supported by specific reasoning and should preferably be submitted in written form.

Comments are requested to be received by **29 October 2010** and may be sent by mail, fax or e-mail to:

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Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

September 2010
Exposure Draft

Response Due Date
29 October 2010

Exposure Draft of HK Interpretation 5

Presentation of Financial Statements – Classification by the Borrower of a Term Loan that contains a Repayment on Demand Clause



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

**EXPOSURE DRAFT
PRESENTATION OF FINANCIAL STATEMENTS –
CLASSIFICATION BY THE BORROWER OF A TERM LOAN THAT CONTAINS A
REPAYMENT ON DEMAND CLAUSE**

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HK Interpretation 5 *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that contains a Repayment on Demand Clause* (HK-Int 5) is set out in paragraphs 1-17. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

The Exposure Draft can also be found on the Institute’s website at:
<http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/exposure-drafts/>.

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This Exposure Draft is prepared by the HKICPA and is intended to seek comments only. Professional advice should be taken before applying the content of this publication to your particular circumstances. While the HKICPA endeavours to ensure that the information in this publication is correct, no responsibility for loss to any person acting or refraining from action as a result of using any such information will be accepted by the HKICPA.

References

- HKAS 1 *Presentation of Financial Statements*
- HKFRS 7 *Financial Instruments: Disclosures*

Background

1. In general, banks normally grant loans that are either demand loans (e.g. loans that are repayable at any time at the discretion of the lender), or term loans (i.e. loans that are repayable on a specified date or in instalments over a specified period, usually in excess of one year). The terms and conditions of the loans are normally stated in the loan agreement or in the loan facility agreement.
2. Typically, the loan agreements for term loans will set out the basic terms, such as the scheduled repayment date(s), interest rates and additional charges for early repayment, and may also include specific clauses which define default events or debt covenant violations which would give the lender the right to accelerate the repayment terms if those events or violations occur.
3. In addition to defining events of default and the consequences of their occurrence, some term loan agreements include an overriding repayment on demand clause, which gives the lender the right to demand repayment at any time at their sole discretion, irrespective of whether a default event has occurred and notwithstanding any other terms and maturity stated in the agreement.
4. The HKICPA noted an issue concerning the classification of term loans with repayment on demand clauses as current/non-current liabilities by entities reporting under HKFRSs. This issue relates to whether such a term loan should be classified by the borrower as a non-current liability based on the scheduled repayment date(s) or as a current liability based on the repayment on demand clause set out in the loan agreement.
5. The purpose of this Interpretation is to provide guidance on the classification by the borrower of a term loan that contains a repayment on demand clause, with reference to the criteria for classification of liabilities as current or non-current as set out in paragraph 69 of HKAS 1. Paragraph 69 states:

“An entity shall classify a liability as current when:

- (a) it expects to settle the liability in its normal operating cycle;*
- (b) it holds the liability primarily for the purpose of trading;*
- (c) the liability is due to be settled within twelve months after the reporting period; or*
- (d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period (see paragraph 73). Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.*

An entity shall classify all other liabilities as non-current.”

Scope

6. This Interpretation applies where an entity has entered into a contract to borrow funds and the contract includes, amongst its terms and conditions, an overriding right for the lender to demand repayment without notice (or with a notice period of less than 12 months) at its sole discretion.
7. This Interpretation does not address the classification of such contracts by the lender.

Issue

8. This Interpretation addresses the issue as to whether a term loan that contains a repayment on demand clause shall be classified as a current or non-current liability in the borrower's statement of financial position in accordance with paragraph 69 of HKAS 1.
9. This Interpretation also addresses the issue as to whether the contractual maturity analysis to be disclosed by the borrower in accordance with paragraph 39(a) of HKFRS 7 should classify the cash flows relating to such term loans based on the contractual repayment dates or with respect to the earliest date on which the lender could demand repayment.

Conclusions

10. The classification of a term loan as a current or non-current liability in accordance with paragraph 69(d) of HKAS 1 shall be determined by reference to the rights and obligations of the lender and the borrower, as contractually agreed between the two parties and in force as of the reporting date. In this regard, the probability of the lender choosing to exercise its rights within the next twelve months after the reporting date is not relevant.
11. The classification of a term loan in accordance with paragraph 69(d) of HKAS 1 shall depend on whether or not the borrower has an unconditional right to defer payment for at least twelve months after the reporting period. Consequently, amounts repayable under a loan agreement which includes a clause that gives the lender the unconditional right to call the loan at any time shall be classified by the borrower as current in its statement of financial position. This is because the borrower under such an agreement does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period.
12. Similarly, in the contractual maturity analysis disclosed by the borrower in accordance with paragraph 39(a) of HKFRS 7, amounts repayable under a loan agreement that includes a clause that gives the lender the unconditional right to call the loan at any time shall be classified in the earliest time bracket, in accordance with the guidance in paragraph B11C(a) of HKFRS 7.

Disclosures

13. In accordance with paragraph 39(c) of HKFRS 7, the borrower shall describe how it manages the liquidity risk inherent in the financial liabilities included in the contractual maturity analysis as required under paragraph 39(a) of HKFRS 7. This would include the liquidity risk that arises when the lender has the right to demand repayment of a term loan at any time.
14. In addition, in accordance with paragraph 34(a) of HKFRS 7, the borrower shall also disclose summary quantitative data on its exposure to liquidity risk based on the information provided internally to management, when this information is prepared on a different basis from that disclosed under paragraph 39(a) of HKFRS 7. This would typically occur in the case of term loans which are callable by the lender, where management does not expect the lender to exercise its rights to demand repayment. In such cases, the internal information on liquidity risk would generally be based on expected repayment dates with reference to the schedule of repayments set out in the term loan agreements. Such expected cash flow information should be disclosed in accordance with paragraph 34(a) of HKFRS 7, in addition to the contractual maturity analysis based on the earliest possible date that the borrower could be required to repay, which is disclosed under paragraph 39(a) of HKFRS 7.

Effective date

15. This Interpretation becomes effective for [date to be inserted after exposure]. Early application is permitted.

Transition

16. Where the initial application of this Interpretation constitutes a change in accounting policy, it should be accounted for retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Consistency with IFRS

17. HKAS 1 and HKFRS 7 are adopted from IAS 1, *Presentation of Financial Statements*, and IFRS 7, *Financial Instruments: Disclosures*, respectively. The HKICPA considers that the Conclusions set out in this Interpretation are consistent with IFRS.