



29 November 2010

Our Ref.: C/FRSC

Dear Sir/Madam,

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"

Thank you for your letter providing your valuable views on the Exposure Draft. As you, and a number of other commentators, expressed concerns at the appropriateness of issuing such an Interpretation, the Financial Reporting Standards Committee (FRSC) of the HKICPA has authorized me to write to all those who expressed such concerns to explain its context and to seek to reassure you that the decision to issue the Interpretation was not taken lightly.

Reasons for issuing HK-Interpretation 5

As you may be aware, since 2005 the HKICPA has been committed to maintaining convergence of HKFRSs with IFRSs, consistent with Hong Kong's status as an international financial centre. Consequently, each and every IFRS standard or Interpretation has been adopted into HKFRSs, virtually word for word and paragraph by paragraph. In addition, the HKICPA has undertaken a range of activities, including publishing technical Q&As in its official magazine *A Plus* and undertaking a broad programme of CPD activities, in order to ensure that Hong Kong's reputation as an IFRS jurisdiction is maintained.

During the course of 2010, the FRSC was asked to consider the practice of some entities in Hong Kong of classifying term loans with repayment on demand clauses as non-current liabilities in their financial statements, based on the schedule of repayments in the loan agreements. Comment letters during the consultation period for the Exposure Draft indicated that this was understood to be a widely accepted practice amongst Hong Kong preparers, which was felt to be consistent with the substance over form principle.

The FRSC noted that paragraph 69 of HKAS 1, *Presentation of Financial Statements*, sets out strict criteria, which, if met, should result in a liability being classified by the borrower as current in a set of financial statements prepared in accordance with HKFRSs. The FRSC compared these criteria with the practice of classifying term loans with repayment on demand clauses as non-current liabilities and reached a preliminary conclusion that such practice appeared to be inconsistent with the requirements of HKAS 1.

As HKAS 1 is a direct copy of IAS 1 of the same name, in August 2010 the FRSC made a submission to the IFRS Interpretations Committee ("the Committee"), the interpretative body of the International Accounting Standards Board, seeking their views on this issue. At its meeting on 3 September 2010, the Committee discussed this issue and noted that paragraph 69(d) of IAS 1 requires a liability to be classified as a current liability if the entity does not have the unconditional right at the reporting



date to defer settlement for at least twelve months after the reporting period. This view was confirmed in the agenda decision published in the November 2010 edition of IFRIC Update, which is available on the IASB's official website:

www.ifrs.org/Updates/Updates.htm

Given the alignment of HKAS 1 and IAS 1, the view of the Committee would need to be regarded as the appropriate conclusion under HKFRSs, even if the HKICPA decided not to issue an Interpretation. However, when determining whether or not to finalise the Interpretation, the FRSC also noted the strength of response to the draft Interpretation, both for and against its conclusions. The comment letters received on the Exposure Draft are available on the Institute's website:

<http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/financial-reporting-submissions/2010/cl-hk-int-5/>

Given the diversity of views received and noting that the issue has widespread implications for financial reporting in Hong Kong, on balance the FRSC decided that the issuance of an Interpretation would be the most effective way of ensuring a common understanding of the requirements of HKAS 1, and would therefore contribute to ensuring continuing consistency of application and full convergence with IFRSs.

The FRSC also took the opportunity in the Interpretation to remind preparers of the requirements of HKFRS 7, *Financial Instruments: Disclosures*, which require entities to explain to users of the financial statements the extent to which management considers that such repayment on demand clauses affect the entity's liquidity risk. These disclosure requirements enable management to explain their perspective on the significance of these clauses to their lending arrangements and also to disclose the contractual repayment schedule which the entity is expecting to follow.

Transition arrangement

The Interpretation is a clarification of an existing standard and shall have immediate effect. To facilitate the implementation of the conclusions of the Interpretation in an orderly manner, the Interpretation states that where its initial application 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*.

Example notes to the financial statements that explain the reason for reclassification of loans with repayment on demand clauses as current liabilities will be developed shortly and made available for preparers adopting the reclassification in the Interpretation.

Please also find in this link the Financial Reporting and Auditing Alert that we have issued on this subject:

http://www.hkicpa.org.hk/file/media/section6_standards/technical_resources/pdf-file/financialauditing/2010/fraa-11.pdf



I hope you have found the above FRSC's comments useful and I look forward to your continued support to ensure that Hong Kong's reputation as an IFRS jurisdiction is maintained.

Yours faithfully,

Steve Ong, FCPA, FCA
Director, Standard Setting

SO/WC/jn