Hong Kong Interpretation 5 Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause

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The HKICPA's Standard Setting Department welcomes your comments and feedback on this paper, which should be sent to commentletters@hkicpa.org.hk.

Summary of HK Interpretation 5

1. "Term loans" are loans which are repayable on a specific date or in instalments over a period of time, usually in excess of one year. Loan facility agreements for such 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 which would give the lender the right to accelerate the repayment terms if those events occur.
2. 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.
3. The purpose of Hong Kong Interpretation 5 *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause* (HK-Interpretation 5) is to set out the conclusions of the FRSC on the question of whether a term loan which is subject to a repayment on demand clause should be classified by the borrower as current or non-current in accordance with the criteria for classification of liabilities as set out in paragraph 69 of HKAS 1 *Presentation of Financial Statements.*
4. The Conclusion reached by the FRSC on this issue is that 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. On this basis, loans subject to loan agreements which include a clause which 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 (balance sheet). 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.

Commonly asked questions regarding the application of HK Interpretation 5

Q1. Why did the HKICPA issue HK Interpretation 5?

Answer:
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 of HK Interpretation 5 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.

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.

In response to members' concerns, the FRSC wrote a letter to all commentators who expressed concerns over the conclusions in the Interpretation explaining the reasons and the importance of issuing HK Interpretation 5. A copy of the letter is available at http://www.hkicpa.org.hk/file/media/section6_standards/technical_resources/pdf-file/smp-sme/2010/dec/hk-int5.pdf

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Q2. When is the effective date and what are the transitional arrangements?

Answer:
HK Interpretation 5 is a clarification of an existing standard and therefore has immediate effect.

Where the initial application of the 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*. In other words, it is necessary to restate previous periods if the loans were classified in those periods on a basis which is inconsistent with the conclusions of the Interpretation.

Q3. Can you provide some examples of:

(a) "Repayment on demand" clauses which, in accordance with HK Interpretation 5, would result in classification of a term loan as a current liability; and

(b) Subjective "events of default" clauses which would not result in such a classification?

Answer:
It should be noted that the terms of a loan agreement are a contract between the borrower and the lender and therefore it is for the lender to decide the terms on which it is prepared to provide the facilities and for the borrower to decide whether those terms are acceptable. Consequently, the examples below are provided for members' information only. The examples are not the only forms of wording of such clauses which can be found in loan agreements and the HKICPA neither encourages nor discourages the inclusion of such clauses in lending agreements. If any party to a contract is in doubt about the consequences of agreeing to borrow or lend on the terms proposed by the other party, then they should seek professional advice.

(a) Examples of contract clauses which, in accordance with HK Interpretation 5 would result in classification of a term loan as a current liability

> *"By signing this letter, you [the Obligor] expressly acknowledge that we [the Lender] may suspend, withdraw or make demand for repayment of the whole or any part of the Facilities at any time notwithstanding the fact that the following covenants/undertakings are included in this letter and whether or not the Guarantor is in breach of any such covenants/undertakings."*

> *"As a general banking practice and notwithstanding any terms and conditions specified above, the Lender reserves its overriding right to cancel or to modify the Facility, or to demand immediate repayment of all outstanding balances whether due or owing, actual or contingent under the Facility without prior notice."*

> *"Notwithstanding any provisions stated in this letter, the Facilities are repayable on demand by the Bank. The Bank has the overriding right at any time to require immediate payment (of all principal, interest, fees and other amounts outstanding under this letter or any part thereof) and/or to require cash collateralization of all or any sums actually or contingently owing to it under the Facilities."*

"Notwithstanding anything contained in this letter, the Facilities are subject to the Bank's overriding right of repayment on demand, to review, amend, and/or cancel any or all of the Facilities at its sole discretion."

(b) Examples of subjective "events of default" clauses

Note: Typically loan agreements contain an extensive list of "events of default" which, if they occur, would entitle the lender to demand immediate repayment. Listed below are examples of those "events of default" that relate to the company's performance and are commonly referred to as "subjective acceleration clauses" as they allow a certain amount of scope for the lender to exercise its judgment. In accordance with paragraphs 74 to 75 of HKAS 1, "events of default" clauses would generally only result in classification of a term loan as a current liability if the event occurred on or before the end of the reporting period and the lender did not provide a waiver or grace period of more than 12 months after the reporting period during which time the lender could not demand immediate repayment as a result of this breach.

"A change in the financial condition occurs in relation to the Group which has, or in the reasonable opinion of the Lenders after due and careful consideration is likely to have, a Material Adverse Effect on:
(a) the business, operations, property or condition (financial or otherwise) of any Obligor or of the Group taken as a whole;
(b) the ability of any Obligor to perform its obligations under the Finance Documents;
(c) the validity, legality or enforceability of this Agreement or the rights or remedies of any Finance Party under the Finance Documents; or
(d) the validity, legality or enforceability of any security expressed to be created under any Security Document or the priority and ranking of such Security."

"Material adverse change: there occurs, in the opinion of the Lender, a material adverse change in the financial condition of any Obligor, or any other event occurs or circumstances arises which, in the opinion of the Lender, is likely materially and adversely to affect the ability of the Obligors (or any of them) to perform all or any of their respective obligations under or otherwise to comply with the terms of any Finance Document to which any of them is party."

"Significant investment which may impair or threaten the right of the Lender to collect the loan and interest"

"Involvement in important economic dispute or deterioration of financial status which may impair or threaten the right of the Lender"

"Significant part of or the entire assets being occupied by other creditors, being taken over by appointed trustee, receiver or other similar entities, or being pledged or frozen which may impair the Lender's right to collect the loan"

"Contracting, leasing, capital restructuring, joint operation, merger, acquisition, joint venture, division, decrease of registered capital, change in shareholding, transfer, or other events which may impair the right of the Lender to collect the loan and its interest"

Q4. Does HK Interpretation 5 apply to a set of financial statements relating to a period ending before the issuance of the Interpretation, if those financial statements are issued after the Interpretation has been issued?

Answer:
Yes, HK Interpretation 5 is applicable for all financial statements that are issued after the issuance of the Interpretation on 29 November 2010.

Q5. The HKICPA's Financial Reporting and Auditing Alert Issue 11 mentions that in some cases, borrowers may be able to obtain "comfort letters" from their lenders indicating that loans will not be called within the next twelve months and therefore the term loans that are subjected to repayment on demand clause would not be classified as current liabilities in the financial statements. Is there any prescribed wording to be followed?

Answer:
There is no standard wording to be followed, as the basis on which a lender is prepared to lend is a matter for the borrower to discuss with the lender on a case by case basis. However, for the letter to be effective it has to be legally enforceable and

the wording needs to be clear that the bank provides an undertaking that it will not exercise the "repayment on demand clause" (i.e. the loan will not be called in) in the period covered by the letter, or that it will only have the right to exercise the clause if some specified trigger default event (such as non-payment of interest or installments on their due date) occurs during that future period (see the answer to question 3 for further guidance on “events of default” wording).

It would not be sufficient if the letter only referred to the lender’s current intentions or expectations about the future, as the conclusion of the Interpretation is that classification is based on contractual rights; the probability of those rights being exercised is not relevant.

Q6. Paragraph 13(1) of the 10th Schedule to the Companies Ordinance requires disclosure of the interest expense on loans, split between those loans wholly repayable within five years and other loans. For the purposes of this disclosure, how should the interest expenses on a term loan repayable on demand be classified?

Answer:
Under paragraph 13(1) loans wholly repayable within five years are defined as loans which

> “(i) are repayable otherwise than by instalments and fall due for repayment before the expiration of the period of 5 years beginning with the day next following the expiration of the financial year; or
>
> (ii) are repayable by instalments the last of which falls due for payment before the expiration of that period.”

From the above it is arguable whether term loans with instalments which fall due after more than five years, but are subject to a repayment on demand clause, should be classified as “wholly repayable within five years” or not. Consequently, in the FRSC’s view either approach is acceptable, provided the approach adopted is applied in a consistent manner and it is clear from the note which approach has been taken.

Q7. Does HK Interpretation 5 apply to companies using (i) HKFRS for Private Entities and (ii) Small and Medium-sized Entity Financial Reporting Standards?

Answer:
Yes. Both HKFRS for Private Entities (paragraph 4.7(d)) and Small and Mediumsized Entity Financial Reporting Standards (paragraph 1.17(d)) contain similar requirements as set out in paragraph 69(d) of HKAS 1, being that a liability should be classified as a current liability if the entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

Consequently, it is the FRSC’s view that although HK Interpretation 5 is issued as a clarification of HKAS 1, the conclusion set out in the Interpretation concerning the classification of a term loan which contains a repayment on demand clause should be considered by management when reporting under “HKFRS for Private Entities” or the “Small and Medium-sized Entity Financial Reporting Standard”.

Q8. Are there any other matters that entities should consider as a result of the issuance of HK Interpretation 5?

Answer:
Matters that might need to be considered as a result of the issuance of HK Interpretation 5 include but not limited to the following:

> (a) Breach of covenants on bank loans and other facilities
> In some cases, the reclassification of a term loan from non-current to current liability might result in a technical breach of covenants contained in the same agreement or in agreements on other forms of credit. Borrowers are encouraged to re-examine the terms of their credit agreements and if they identify any breaches of covenants, to discuss or negotiate with the credit providers before the end of the reporting period with a view to obtaining a waiver or a grace period ending at least twelve months after the reporting period, within which the lender cannot demand immediate repayment, or will only have the right to demand repayment if some further specified trigger default event (such as non-payment of interest or installments on their due date) occurs during that future period (see the answer to question 4 for further guidance on “events of default” wording).

(b) Disclosure of price sensitive information
Companies listed on the Hong Kong Stock Exchange are required under Rule 13.09 of the Main Board Listing Rules to keep the Exchange, members of the issuer and other holders of its listed securities informed of price sensitive information i.e. information which could have a material impact on the price of the listed securities if it is made public. Similar rules apply to companies listed on the Growth Enterprise Market. The Hong Kong Stock Exchange, in its Guide on Disclosure of Price-Sensitive Information, has given some examples of price sensitive information, and these include any change of accounting policy that may have a significant impact on the financial statements. Management should consider the issuer's own circumstances when judging whether the reclassification of a term loan would have a significant impact on the financial statements or may otherwise have a significant impact on the issuer's financial position and may therefore constitute price sensitive information.

(c) Effect of reproduction of issued financial statements
From time to time an entity may need to reproduce the financial statements that have been previously published, for example for the purpose of issuing an investment circular. If those financial statements were published before the Interpretation was issued and contain loans which were classified on a basis which is inconsistent with the conclusions of the Interpretation, care should be taken to ensure that the reader of the re-produced information is aware of the nature of the borrowings and the classification that would be required by the Interpretation.

Q9. As a result of showing the full outstanding balance of the term loan with a payment on demand clause as current, my company now has net current liabilities. Does this mean that going concern uncertainties should be disclosed in the financial statements and that the auditor will have to modify the audit report?

Answer:
The answer to this question will depend on the company's facts and circumstances as follows:

When preparing financial statements, HKAS 1 requires that management should make an assessment of an entity's ability to continue as a going concern. In making this assessment, management may need to consider a wide range of factors relating to the company's current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate. Since presenting term loans as current liabilities in the balance sheet is simply reflecting existing contractual terms between the lender and the borrower, adopting the Interpretation should not, in and of itself, change the assessment that the entity is a going concern, unless the presentation of net current liabilities has further consequences on the entity's circumstances, such as giving rise to a breach of a covenant in a lending agreement.

In terms of disclosure in the financial statements, HKAS 1 requires that when management is aware, in making its assessment, of material uncertainties related to events or conditions which may cast significant doubt upon the enterprise's ability to continue as a going concern, those uncertainties should be disclosed. The extent of disclosure will therefore vary from entity to entity. However, where an entity presents net current liabilities, it would generally be the case that the financial statements will include some disclosure in response to this situation. This disclosure would either discuss the significant uncertainties facing the company, and any mitigating factors which will assist the company in continuing as a going concern, or, if there are no such uncertainties (i.e. notwithstanding the net current liability position), a negative statement would be made to that effect for the avoidance of doubt. This might be the case, for example, if the presentation of net current liabilities is solely as a result of the adopting Interpretation, the presentation of net current liabilities has no consequential impact on the company's circumstances, for example, there are no lending covenants which are breached as a result.

So far as the audit report is concerned, it is necessary for the auditor to include an emphasis of matter paragraph in the auditreport if the use of the going concern assumption is appropriate but there exists a material uncertainty about the future of the entity. In this regard, paragraph A2 of HKSA 570, *Going Concern*, identifies a net current liability position as an example of a condition which individually, or collectively together with other events or conditions, may cast significant doubt about the going concern assumption. However, this paragraph also confirms that the existence of this condition (or any of the other examples listed) does not always signify that a material uncertainty exists. Therefore, it is a matter of judgement for the auditor as to whether he/she considers it necessary to modify the audit report in accordance with the requirements of HKSA 570 where a company has net current liabilities.

Companies should seek professional (legal and/or accounting) advice if in doubt about the implications of adopting the Interpretation.