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

Illustrative examples on classification of liabilities as current or non-current

In August 2020, the HKICPA issued *Classification of Liabilities as Current or Non-current* - Amendments to HKAS 1 *Presentation of Financial Statements* (2020 Amendments) which clarified certain aspects of how entities classify liabilities as current or non-current. In December 2022, the HKICPA issued further amendments to HKAS 1 *Non-current Liabilities with Covenants* (2022 Amendments) which clarified how conditions with which an entity must comply in a loan arrangement affect the classification of the loan as current or non-current and deferred the effective date of the 2020 Amendments. Both the 2020 Amendments and the 2022 Amendments (collectively "the Amendments") are to be applied as a package and are effective for annual reporting periods beginning on or after 1 January 2024, with early adoption permitted. Entities will need to apply these Amendments retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*

The Amendments affect only the presentation of liabilities as current or non-current in the statement of financial position and disclosure of liabilities in the notes to the financial statements, and not the recognition or measurement of these liabilities. However, the Amendments may change the classification of some liabilities from current to non-current, and vice versa, potentially affecting those entities' compliance with loan covenants. Consequently, entities are recommended to assess the potential impact of the Amendments early and if the Amendments could change the classification of certain liabilities from non-current to current, entities may want to consider renegotiating covenants or other terms of the agreements with the banks or other financial institutions.

Furthermore, in reporting periods before the Amendments are effective, entities are required to disclose known or reasonably estimable information relevant to assessing the possible impact of application of the Amendments on their financial statements [paragraph 30 of HKAS 8[1]].

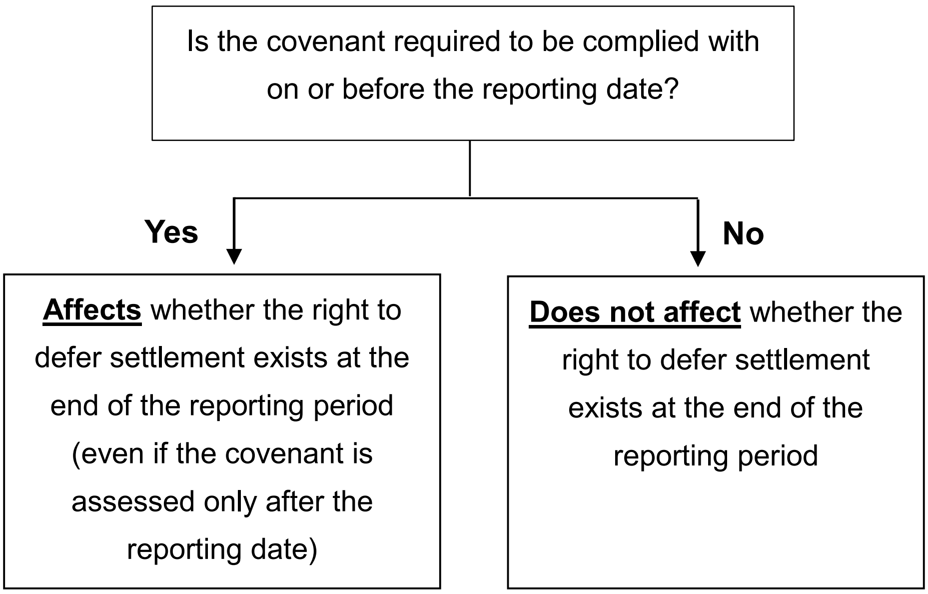
Key changes from the current HKAS 1 due to the Amendments

Right to defer settlement for at least twelve months

1. The word "unconditional" has been removed from paragraph 69 of HKAS 1 so that this paragraph no longer refers to an "unconditional" right to defer settlement. A new paragraph has been added which requires that an entity's right to defer settlement for at least twelve months after the reporting period must have substance and exist at the end of the reporting period. [paragraph 72A of HKAS 1]

Liabilities with covenants

2. An entity's right to defer settlement may be subject to its compliance with covenants specified in a loan arrangement. The Amendments clarify that covenants with which an entity must comply *after* the reporting date do not affect the classification of a liability as current or non-current at the reporting date (i.e. future covenants). However, covenants with which an entity is required to comply *on or before* the reporting date affect the classification, even if the covenant is assessed only after the entity's reporting date. [paragraph 72B of HKAS 1] [see Example 1, Example 2 and Example 3]



[1]Applying paragraph 30 of HKAS 8, when an entity has not applied a new HKFRS that has been issued but is not yet effective, the entity shall disclose this fact and known or reasonably estimable information relevant to assessing the possible impact that application of the new HKFRS will have on the entity's financial statements in the period of initial application.

Management's expectations

3. The Amendments clarify that a liability's classification as current or non-current is unaffected by management's intentions or expectations about whether an entity will exercise its right to defer settlement of the liability for at least twelve months after the reporting period. If a liability meets the criteria in paragraph 69 of HKAS 1 to be classified as non-current, it is classified as non-current even if management intends or expects the entity to settle the liability within twelve months after the reporting period, or even if the entity settles the liability between the end of the reporting period and the date the financial statements are authorised for issue. [paragraph 75A of HKAS 1] [see Example 3]

4. The Amendments also align the terminology by replacing "discretion" with "right" in paragraph 73 of HKAS 1 and clarify that the classification principle requires an entity to assess whether it has the right to defer settlement of a liability and not whether it will exercise that right. [paragraph 73 of HKAS 1] [see Example 3]

Settlement by way of own equity instruments

5. The Amendments clarify the meaning of "settlement" for the purpose of classifying a liability as current or non-current. Settlement refers to a transfer to the counterparty that results in the extinguishment of the liability. The transfer could be of cash, goods or services, or the entity's own equity instruments. [paragraph 76A of HKAS 1]

6. The Amendments also clarify how an entity classifies a liability that can be settled in its own equity instruments, e.g. convertible debt. If a liability has terms that could, at the option of the counterparty, result in its settlement by the transfer of the entity's own equity instruments, these terms do not affect its classification as current or non-current if the conversion option is accounted for as equity under HKAS 32 *Financial Instruments: Presentation*. In other cases, the transfer of equity instruments would constitute settlement of the liability for the purpose of classifying it as current or non-current (e.g. if an obligation to transfer equity instruments is accounted for as a derivative). [paragraph 76B of HKAS 1] [see Example 4]

Liabilities that can be settled in a company's own shares (e.g. convertible debts)

Conversion option meets the definition of an **<u>equity instrument</u>**

Timing of when share settlement can take place **<u>does not affect</u>** the classification of the host liability as current or non-current

Conversion option does **<u>not</u>** meet the definition of an **<u>equity instrument</u>**

Timing of when share settlement can take place **<u>affects</u>** the classification of the host liability as current or non-current

Disclosure requirements

7. The Amendments introduce additional disclosure requirements for non-current liabilities that are subject to future covenants (see paragraph 2 above). The disclosures aim to enable investors to assess the risk that those liabilities could become repayable within twelve months after the reporting date. These disclosures include i) information about the covenants and the carrying amount of the related liabilities; and ii) facts and circumstances, if any, that indicate the entity may have difficulty complying with the covenants. [paragraph 76ZA of HKAS 1] [see Example 1, Example 2 and Example 3]

Illustrative examples

In this publication, we provide examples to illustrate the application of the Amendments in classifying some common loan arrangements in Hong Kong. Since the term "loan arrangement" is not defined in the extant HKAS 1 or in the Amendments, entities will need to exercise judgement to determine what constitutes a loan arrangement within the context of the revised HKAS 1 when classifying liabilities as current or non-current.

In these examples, we assume that the entity's right to defer settlement of the liabilities has substance under paragraph 72A of HKAS 1. In addition, these examples are simplified for illustration purposes only. In practice, the terms of loan arrangements may be different from and/or more complicated than those in this publication and there may be additional clauses in the loan arrangements that could impact the classification of the loans as current or non-current. For example, certain loan arrangements contain an overriding repayment on demand clause which gives the lender the right to demand repayment at any time at its sole discretion, irrespective of whether a default event has occurred and notwithstanding any other terms and maturity stated in the arrangement. In accordance with HK Interpretation 5 (Revised) *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause*, loan arrangements containing such clauses shall be classified as current applying paragraph 69(d) of HKAS 1 because the borrower does not have the right to defer settlement of the loan for at least twelve months after the reporting period under such an arrangement. Entities may need to perform additional analysis and seek professional advice when necessary.

Example 1: Term loan with financial covenants

Common facts for variations 1, 2 and 3:

Company A enters into a 3-year loan agreement with a bank on 1 March 20X3. Among the terms and conditions as stipulated in the loan agreement, the bank has a right to demand full repayment of the loan immediately if Company A does not comply with specified covenants. Company A's reporting period ends on 31 December 20X3.

<u>Variation 1</u>

The covenant is that Company A must comply with a specified debt to equity ratio as at each calendar year-end. Company A breaches the covenant on 31 December 20X3 but obtains a waiver in respect of the breach under cases A to C. The terms of the waiver provide Company A with a period of grace and during this time the bank cannot demand repayment as a result of the breach.

Case A – The waiver obtained before year-end is for a period of <u>more than</u> twelve months after the reporting period.

Case B – The waiver obtained before year-end is for a period of <u>less than</u> twelve months after the reporting period.

Case C – The waiver is obtained after year-end but before the financial statements are authorised for issue.

Analysis:

	Case A	Case B	Case C
Does Company A have the right to defer settlement for at least twelve months after the reporting date?	Yes	No	No
Classification of the loan at the reporting date	Non-current	Current	Current

Case A

Applying paragraphs 72B(a) and 74 of HKAS 1, in the absence of the waiver, Company A does not have the right to defer settlement of the loan for at least twelve months after the reporting period because of the breach of the covenant at year-end. However, the waiver in respect of the breach was obtained before the end of the reporting period which provided Company A with the right to defer settlement of the loan for at least twelve months after the reporting period. Applying paragraph 75 of HKAS 1, the loan under Case A is classified as non-current as at 31 December 20X3.

Case B

The waiver under Case B provides Company A with the right to defer settlement of the loan for a period of less than twelve months after the reporting period. The requirements in paragraph 75 of HKAS 1 are not met in this case and the loan under Case B is classified as current as at 31 December 20X3 due to the breach of the covenant test at the reporting date.

Case C

Applying paragraphs 72B(a) and 74 of HKAS 1, the loan under Case C is classified as current as at 31 December 20X3 even though the lender has agreed, after the reporting date but before the financial statements are authorised for issue, not to demand payment as a consequence of the breach. Since Company A only obtained the waiver after year-end, it does not have a right at the reporting date to defer the settlement of the loan for at least twelve months after the reporting period.

Variation 2

The covenant is assessed based on Company A's financial position after the reporting period (e.g. 31 March of the following year).

Analysis:

Paragraph 72B(b) of HKAS 1 states that if an entity is required to comply with a covenant only after the reporting period, such covenant does not affect whether the right to defer settlement exists at the end of the reporting period. In this example, Company A is required to comply with the covenant only after the year-end. The covenant does not affect Company A's right to defer settlement as at year-end. Therefore, the loan is classified as non-current as at 31 December 20X3.

Also, Company A is required to disclose information in the notes to the financial statements, including (i) information about the covenant and the carrying amount of the loan; and (ii) facts and circumstances, if any, that indicate Company A may have difficulty complying with the covenants in accordance with paragraph 76ZA of HKAS 1.

Variation 3

The covenant is assessed based on certain metrics or ratios determined using the audited financial statements for each financial year ending 31 December that are provided to the bank on 31 March of the following year. Company A must comply with the covenant as at each calendar year-end. Based on the audited financial statements, Company A breaches the covenant as at 31 December 20X3.

Analysis:

Paragraph 72B(a) of HKAS 1 states that a covenant affects whether an entity's right to defer settlement for at least twelve months after the reporting period exists at the reporting date if an entity is required to comply with the covenant on or before the end of the reporting period even if compliance with the covenant is assessed only after the reporting period. In this example, even though the covenant is tested after year-end, Company A does not have the right to defer settlement of the loan for at least twelve months after the reporting period because it has breached the covenant as at the year-end. Therefore, the loan is classified as current as at 31 December 20X3.

Disclosures of breaches

There are a few cases in this example where Company A breaches the covenants at the end of the reporting period and those breaches permit the bank to demand immediate payment. Applying paragraph 18 of HKFRS 7 *Financial Instruments: Disclosures*, Company A is required to disclose i) details of the breaches during the period; ii) the carrying amount of the related loans at the reporting date; and iii) whether the breach was remedied or the terms of the loans were renegotiated before the financial statements were authorised for issue.

Example 2: Term loan with non-financial covenants/conditions

Company B enters into a 3-year loan agreement with a bank on 1 March 20X3. Among the terms and conditions as stipulated in the loan agreement, the bank has a right to demand full repayment of the loan immediately upon the occurrence of certain events (i.e. the "covenants/conditions") as described in Cases 1 to 3 below. Company B's reporting period ends on 31 December 20X3.

Case 1 – a change in Company B's controlling shareholders

Case 2 – deterioration of Company B's external credit risk rating (e.g. from investment grade to non-investment grade)

Case 3 – failure to complete an initial public offering by 30 June 20X4

Analysis:

<u>Case 1 and Case 2</u>

Paragraph 72B of HKAS 1 states that covenants/conditions with which an entity must comply on or before the reporting date affect the classification of a liability as current or non-current at the reporting date while covenants/conditions with which an entity must comply after the reporting date do not affect the classification.

Case 1 and Case 2 do not specify when the entity is required to comply with the covenants/conditions. If there is no actual breach of the covenants/conditions on or before the reporting date, applying paragraphs 72B(a) and 74 of HKAS 1, Company B has the right to defer settlement of the loan for at least twelve months after the reporting period and so the loan is classified as non-current as at 31 December 20X3. If, on the other hand, Company B has breached these covenants/conditions on or before the reporting date, the loan would be classified as current at the reporting date.

<u>Case 3</u>

Paragraph 72B(b) of HKAS 1 states that if an entity is required to comply with a covenant/condition only after the reporting period, such covenant/condition does not affect whether the right to defer settlement exists at the end of the reporting period. Company B is required to comply with the covenant/condition only after the year-end. The covenant/condition does not affect Company B's right to defer settlement as at year-end. As the loan is repayable in three years' time, it is classified as non-current as at 31 December 20X3.

Disclosures

For Cases 1-3 above, Company B is required to disclose information in the notes to the financial statements, including (i) information about the covenant/condition and the carrying amount of the loan; and (ii) facts and circumstances, if any, that indicate Company B may have difficulty complying with the covenants/conditions in accordance with paragraph 76ZA of HKAS 1.

Example 3: Revolving loan facility

Facts:

Company C enters into a 3-year revolving loan facility with a bank. The facility is fully drawn down on 1 February 20X3 as a one-year loan with repayment due on 31 January 20X4. Company C has the right to roll over the loan for another year subject to complying with an annual covenant test, which requires Company C to maintain a specified debt to equity ratio on 31 January each year. The bank will test compliance with the loan covenant before rolling over the loan. The loan will be rolled over at the borrower's sole discretion (i.e. the lender cannot reject the roll over request) as long as the loan covenant is complied with. Management intends to roll over the loan on 31 January 20X4 and settle the loan by the end of 20X4. Company C's reporting period ends on 31 December 20X3.

Analysis:

In this example, the facility is drawn down as a one-year loan with a repayment date within twelve months after the reporting date (i.e. on 31 January 20X4). However, paragraph 69(c) of HKAS 1 does not apply in this case because Company C has the right to roll over the loan for another year subject to an annual covenant test on 31 January each year. Company C therefore assesses whether it has the right to defer settlement for at least twelve months after the reporting period (paragraph 69(d) of HKAS 1). In performing such an assessment, paragraph 73 of HKAS 1 sets out specific requirements for roll over obligations − if an entity has the right, at the end of the reporting period, to roll over an obligation for at least twelve months after the reporting period under an existing loan facility, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period.

Since its "right" to roll over the loan is subject to complying with an annual covenant test, Company C applies paragraph 72B of HKAS 1 which is applicable to all loan arrangements, including long-term revolving loan facilities. In this example, Company C is required to comply with the covenant only after the reporting period. Applying paragraph 72B(b) of HKAS 1, the covenant does not affect the determination of whether Company C has the right to defer settlement for at least twelve months after the end of the reporting period. At the reporting date (i.e. 31 December 20X3), Company C has the right to defer settlement of the liability under the revolving loan facility for at least twelve months after the reporting period, and hence it is classified as non-current as at 31 December 20X3.

Even though management intends to settle the loan within twelve months after the reporting period (i.e. by the end of 20X4), such intention does not affect the classification of the loan as current or non-current applying paragraph 75A of HKAS 1. However, Company C may need to disclose information about the expected timing of settlement to enable users of its financial statements to understand the impact of the loan on its financial position (paragraph 17(c) of HKAS 1).

Also, paragraph 76ZA of HKAS 1 requires Company C to disclose information in the notes to the financial statements that enables users of financial statements to understand the risk that non-current liabilities with future covenants could become repayable within twelve months after the reporting period.

Notes:

In this example, Company C has the right to roll over the loan which is conditional on compliance with the loan covenant annually on 31 January. Prior to the Amendments, HKAS 1 required an entity's right to defer settlement of a loan to be "unconditional", failure of which would have resulted in a current classification of the revolving loan in this example. The Amendments replaced "an unconditional right" with "a right at the end of the reporting period", and so the loan drawn down under the revolving loan facility will be classified as non-current if Company C has a conditional right to roll over the loan at the end of the reporting period, which is subject to the compliance with the covenant after the reporting date.

This example is simplified for illustration purposes. In practice, the revolving loan facility may have different and/or more complicated terms than those in this example. Entities may need to perform additional analysis and seek professional advice when necessary.

Example 4: Convertible bonds

4(a) Functional currency-denominated convertible bond

Facts:

Company D has a Hong Kong dollar (HKD) functional currency and it issues a five-year HKD-denominated convertible bond on 1 May 20X3 that matures on 30 April 20X8. The convertible bond includes a contractual obligation to deliver cash to the holder of the bond at maturity (host liability) and a conversion option. The holder has the option to convert the bond into a fixed number of Company C's ordinary shares at any time before maturity at the holder's discretion. The convertible bond is a compound financial instrument. Applying HKAS 32, the conversion option is recognised as an equity instrument separately from the host liability. Company D's reporting period ends on 31 December 20X3.

Analysis:

Applying paragraph 76B of HKAS 1, the conversion option does not affect the classification of the host liability as current or non-current because the conversion option is separately classified as an equity instrument. The host liability matures on 30 April 20X8 and, therefore, it is classified as non-current as at 31 December 20X3 applying paragraph 69 of HKAS 1 despite the fact that the liability could be extinguished due to conversion into shares within the next twelve months.

4(b) Foreign currency-denominated convertible bond

Facts:

The facts are the same as those in Example 4(a), except the functional currency of Company D is Renminbi (RMB). The conversion option does not meet the definition of equity instrument in HKAS 32 because it obliges Company D to exchange a variable amount of cash in RMB for a fixed number of its own equity instruments (i.e. it fails the "fixed-for-fixed" criterion in HKAS 32). The conversion option is recognised as an embedded derivative separately from the host liability applying paragraph 4.3.3 of HKFRS 9 (unless Company D designates the entire instrument under the fair value option).

Analysis:

Given the conversion option is not classified as an equity instrument in terms of HKAS 32, paragraph 76B of HKAS 1 is not applicable. The transfer of Company D's equity instruments is a form of settlement applying paragraph 76A of HKAS 1. Since the holder has an option to convert the bond into Company D's ordinary shares at any time at the holder's discretion, Company D does not have the right to defer settlement for at least twelve months after the reporting period. Therefore, the host liability (or the entire convertible bond if it is designated in its entirety as a financial liability at fair value through profit or loss) is classified as current as at 31 December 20X3 applying paragraph 69(d) of HKAS 1.

Notes:

Settlement by way of own equity instruments

A transfer of the entity's own equity instruments is treated as an outflow of economic resources if the obligation to make that transfer is classified as a liability. This is because paragraph 4.26 of *Conceptual Framework for Financial Reporting* defines a liability as a present obligation to transfer an economic resource as a result of past events.

Paragraph 21 of HKAS 32 explains that if an entity has a contractual obligation to deliver a variable number of its own equity instruments, such contractual obligation is not an equity instrument of the entity. Paragraph BC10(b) of HKAS 32 explains that such contractual obligation is a liability because the entity is using its own equity instruments "as currency", which is an economic resource.

Observation

The clarification of the meaning of "settlement" in the Amendments might result in a significant change for entities that currently only consider the date at which cash payment is required and any early redemption options when classifying the host liability of a convertible bond as current or non-current. Some entities may have ignored the conversion options when making this classification as the exercise of such options neither have any cash flow effect nor affect the liquidity position of the issuers. Therefore, practice may change following the adoption of the Amendments.