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

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Sent electronically through the IASB Website (www.ifrs.org)

10 June 2015

Mr Hans Hoogervorst
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Hans,

IASB Exposure Draft ED/2015/1 *Classification of Liabilities*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to set and promulgate standards relating to financial reporting, auditing and ethics for professional accountants in Hong Kong. We are grateful for the opportunity to provide you with our comments on this Exposure Draft (ED).

We support the IASB's initiative to clarify the criteria for classification of a liability as current or non-current. We generally agree with most of the proposed amendments but have serious concerns about deleting the term 'unconditional' from paragraph 69(d) of the existing IAS 1 *Presentation of Financial Statements*. The term 'unconditional' carries paramount significance in the determination of a liability's classification in Hong Kong. We consider that deleting this term may have unintended consequences on the classification of a liability.

Our responses to the questions raised in the ED are explained in more detail in Appendix 1.

If you have any questions regarding the matters raised in this letter, please contact me or Eky Liu, Associate Director of Standard Setting, at eky@hkicpa.org.hk.

Yours sincerely,

Christina Ng
Head of Financial Reporting

CN/EL

Encl.

Appendix 1

Detailed comments on IASB ED/2015/1 *Classification of Liabilities*

<u>Question 1</u>

The IASB proposes clarifying that the classification of liabilities as either current or non-current should be based on the entity's rights at the end of the reporting period. To make that clear, the IASB proposes:

(a) replacing 'discretion' in paragraph 73 of the Standard with 'right' to align it with the requirements of paragraph 69(d) of the Standard;

(b) making it explicit in paragraphs 69(d) and 73 of the Standard that only rights in place at the reporting date should affect this classification of a liability; and

(c) deleting 'unconditional' from paragraph 69(d) of the Standard so that 'an unconditional right' is replaced by 'a right'.

Do you agree with the proposed amendments? Why or why not?

We generally support the proposals in the ED:
(i) to clarify the classification principles in the existing standard by removing inconsistencies in the terms used in paragraph 69(d) and paragraph 73 of IAS 1; and
(ii) to state explicitly in paragraphs 69(d) and paragraph 73 that only rights in place at the reporting date should affect the classification of a liability.

However, we do not support the proposal to delete the term 'unconditional' from paragraph 69(d) of IAS 1.

In Hong Kong, it is common for some term loan agreements to specify a repayment schedule over time in excess of one year <u>and</u> include an overriding repayment on demand clause, which gives lenders the right to demand repayment at any time at their sole discretion and irrespective of whether a default event has occurred. In 2010, the Institute was asked to consider the practice of some entities in Hong Kong that classify such term loans as non-current liabilities. It was the term 'unconditional' in paragraph 69(d) of IAS 1 that provided clarity that, in such circumstance, despite a repayment schedule, the lender has an unconditional right to call the loan at any time, and accordingly, the borrower does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Considering the wide spread implications in Hong Kong, the Institute issued Interpretation 5 *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause* (Appendix 2) to re-emphasise the term 'unconditional' when classifying such term loans. Therefore, we strongly disagree with the view expressed in paragraph BC2 of the ED that the lack of clarity in the classification principles arises in part through the use of 'unconditional' in paragraph 69(d) and that rights to defer settlement are rarely unconditional.

We understand that some jurisdictions in the Asian-Oceanian region also share the same concern about deleting the word 'unconditional' from paragraph 69(d) of IAS 1.

In light of the above, we believe that the term 'unconditional' has paramount significance in the determination of a liability's classification, and deleting the term 'unconditional' from paragraph 69(d) might have unintended consequences to the classification of liabilities.

If the IASB were to proceed with this proposal to delete the term 'unconditional', we strongly recommend that the IASB provide further guidance or clarity in IAS 1 to address the following situations:

(i) We were informed that it is common for a borrower to have a right to defer settlement of a liability subject to condition(s) that can only be met after the reporting date. For example, the right to defer settlement may be dependent on loan-to-value ratio of a collateral asset as at a date after the reporting period. Further guidance on how to determine whether the borrower has a right in place to defer settlement as at the reporting date would be necessary.

(ii) As mentioned above, it is common for some term loans to be callable by the lender at any time irrespective of a repayment schedule beyond one year. The IASB should clarify in its application guidance that a borrower should classify such term loans as current in its statement of financial position. It would also be helpful if the IASB adds this clarification in its application guidance even if it were to keep the term 'unconditional'.

Question 2

The IASB proposes making clear the link between the settlement of the liability and the outflow of resources from the entity by adding 'by the transfer to the counterparty of cash, equity instruments, other assets or services' to paragraph 69 of the Standard.

Do you agree with that proposal? Why or why not?

We support this proposal to state explicitly the link between the settlement of the liability and the transfer of resources. This proposal would also clarify that rollover of the borrowing does not constitute 'settlement' and would not result in the liability being classified as current.

However, we would like to clarify whether settlement by equity instruments would affect the classification of liability as current or non-current. We note that in paragraph 69(d) of the IAS 1 states that "terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do no affect its classification" and, in particular, paragraphs BC38G and BC38H of the existing IAS 1 respectively state that:

- liquidity and solvency are associated with the availability of cash to an entity. Issuing equity does not result in an outflow of cash or other assets of the entity; and
- classifying the liability on the basis of the requirements to transfer cash or other assets rather than on settlement better reflects the liquidity and solvency position of an entity.

We understand that these paragraphs relate to the classification of the liability component of a convertible instrument. However, this seems to be inconsistent with the proposed additional wording in paragraph 69, which states "for the purposes of classification, settlement of liability refers to the transfer to the counterparty of cash, <u>equity instruments</u> *(emphasis added)*, other assets or services". We believe that the settlement of a liability by issuing an entity's own equity instruments would not affect the classification of such liability as issuing own equity does not result in an outflow of cash or other assets of the entity. Accordingly, we consider it is necessary to align the intention of the proposed additional text in paragraph 69 with the meaning of paragraph 69(d) of the existing IAS 1.

Question 3

The IASB proposes that the proposed amendments should be applied retrospectively.

Do you agree with that proposal? Why or why not?

We support applying the proposed amendments retrospectively as the proposed amendments only clarify existing requirements rather than imposing additional requirements. Furthermore, the proposal would be consistent with the existing requirement in paragraph 41 of IAS 1, which states that comparative amounts should be reclassified if an entity changes the presentation of items in its financial statements and that would result in comparable financial information.

~ End ~

Appendix 2

HK Interpretation 5
Issued 29 November 2010

This Interpretation is a clarification of an existing standard, HKAS 1 *Presentation of Financial Statements*, and shall have immediate effect.

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

HK INTERPRETATION 5
PRESENTATION OF FINANCIAL STATEMENTS – CLASSIFICATION BY THE BORROWER OF A TERM LOAN THAT CONTAINS A REPAYMENT ON DEMAND CLAUSE

CONTENTS

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 1-18. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

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 is a clarification of an existing standard and shall have immediate effect.

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 IFRSs

17. HKAS 1 and HKFRS 7 are adopted from IAS 1, *Presentation of Financial Statements*, and IFRS 7, *Financial Instruments: Disclosures*, respectively.

18. Prior to the issuance of this Interpretation, the HKICPA submitted an agenda request to the IFRS Interpretations Committee ("the Committee") concerning the issue set out in paragraph 8 of this Interpretation. The Committee discussed this issue at its meeting on 3 September 2010 and noted that paragraph 69(d) of IAS 1 requires that a liability must 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. The Committee confirmed its view in the agenda decision which was published in the November 2010 edition of IFRIC Update and which is available on the IASB's official website (www.ifrs.org/Updates/Updates.htm). Consequently, the HKICPA considers that the Conclusions set out in this Interpretation are consistent with IFRSs.