Can you provide some examples of “repayment on demand” clauses that, in accordance with HK Interpretation 5, would result in the classification of a term loan as a current liability; and subjective “events of default” clauses that would not result in such a classification?

The terms of a loan agreement are a contract between the borrower and the lender. It is up to the lender to decide the terms on which it is prepared to provide the facilities and the borrower to decide whether those terms are acceptable. Consequently, the examples below are provided for members’ information only. They are not the only forms of wording of such clauses that can be found in loan agreements and the Institute 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, they should seek professional advice.

Examples of “repayment on demand” clauses

“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.”

Examples of subjective “events of default” clauses

Loan agreements typically 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 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 the 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.

“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 a party.”

“Significant investment that 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.”

Q 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?

A HK Interpretation 5 is applicable to all financial statements that are issued after the issuance of the interpretation on 29 November.

Q The Institute’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 12 months, and therefore the term loans that are subjected to repayment on demand clauses would not be classified as current liabilities in the financial statements. Is there any prescribed wording to be followed?

A There is no standard wording to be followed, as the borrower will have to discuss with the lender the basis on which the latter is prepared to lend. 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” (that is, the loan will not be called in) during 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 instalments on their due date, occurs during that future period.

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.
Q 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 purpose of this disclosure, how should the interest expenses on a term loan repayable on demand be classified?

A 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 five-year period 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 that 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 committee’s view, either approach is acceptable, provided it is applied consistently and the note clearly indicates which approach has been taken.

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

A Yes. Both paragraph 4.7(d) of HKFRS for Private Entities and paragraph 1.17(d) of the Small- and Medium-sized Entity Financial Reporting Standards contain similar requirements as set out in paragraph 69(d) of HKAS 1. They state 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, the committee’s view is 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 that 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.

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

A Matters that might need to be considered include but are not limited to:

**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. If they identify any breaches of covenants, they should discuss or negotiate with the credit providers before the end of the reporting period to obtain a waiver or a grace period ending at least 12 months after the reporting period. That way, during that period, 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 instalments on their due date) occurs.

**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 information that 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 such information, which includes 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.

**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 that is inconsistent with the conclusions of the interpretation, care should be taken to ensure that the reader of the reproduced information is aware of the nature of the borrowings and the classification that would be required by the interpretation.

**Q** 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?

**A**
This will depend on the company’s facts and circumstances.
When preparing financial statements, HKAS 1 requires that management should assess an entity’s ability to continue as a going concern. In making this assessment, management may need to consider 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 management, when making its assessment, disclose material uncertainties related to events or conditions that may cast significant doubt upon the enterprise’s ability to continue as a going concern. 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 that will assist the company in continuing as a going concern. If there are no such uncertainties (that is, 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 adopting the interpretation, or the presentation of net current liabilities has no consequential impact on the company’s circumstances (for example, there are no lending covenants that 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 report if the use of the going concern assumption is appropriate but there exists a material uncertainty about the entity’s future. In this regard, paragraph A2 of HKSA 570 *Going Concern* identifies a net current liability position as an example of a condition that 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 up to the auditor to judge whether he or 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 legal and accounting advice if in doubt about the implications of adopting the interpretation.
For the full Q&A on the Interpretation 5, visit the Institute’s website under standards and regulation/standards/financial reporting/accounting bulletins and circulars.

Send your questions and comments to commentletters@hkicpa.org.hk for the attention of Steve Ong, the Institute’s director of standard setting. The standard setting team will answer these questions in accordance with its policy, posted on the Institute’s website.