Project **IAS 1 *Presentation of Financial Statements***

Topic **Current/ non-current classification of callable term loan**

Purpose of this agenda paper

1. The IFRS Interpretations Committee received a request from a national standard setter regarding the classification as current or non-current for term loan that is callable by the lender at anytime. This paper provides a copy of the request and requests the Committee to answer questions raised by the staff.

Issue analysis

Background

2. In August 2010, the Committee received a request from the Hong Kong Institute of Certified Public Accountants (HKICPA) requesting views of the Committee. The issue regards the classification as current or non-current for term loan that is callable by the lender at anytime. The staff notes that the HKICPA has analysed the issue in its cover letter to the Committee. In the staff's opinion, the HKICPA's analysis provides the relevant authoritative references and presents two views for consideration. Therefore, the staff requests the Committee review the submission included as Appendix A to this paper.

Committee agenda criteria

3. The staff's assessment of the Committee's agenda criteria is as follows:

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRS Interpretations Committee or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*.

Interpretations are published only after the IFRS Interpretations Committee and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

(a) *The issue is widespread and has practical relevance.*

Yes. The staff notes that the classification of liabilities as current vs non-current is common in jurisdictions applying IFRSs.

(b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

No. In the staff's opinion, significant diversity is not expected to occur in practice.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

n/a. In the staff's opinion, there is a prevalent view in practice.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

n/a. In the staff's opinion, the issue may be self resolved within the confines of existing IAS 1 without the need for the interpretation process.

(e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

n/a. In the staff's opinion, no formal interpretation is needed as far as the application of current IAS 1 is concerned.

(f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*

No. There is no current or planned IASB project covering the issue.

Annual Improvements *agenda criteria*

4. The staff notes the proposed criteria for *Annual Improvements* was discussed at the June 2010 *IFRS Advisory Council*. The observer note for that meeting included an Appendix – *Proposed criteria for assessing individual issues for*

inclusion in Annual Improvements that included the following four proposed criteria that must all be satisfied:

(a) The proposed amendment has one or both of the following characteristics:

(i) **Clarifying:** The proposed amendment improves IFRSs through one or both of the following:

(a) Clarifying unclear wording in existing IFRSs.

(b) Providing guidance where a current lack of guidance is causing concern.

A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.

(ii) **Correcting:** The proposed amendment improves IFRSs through one or both of the following:

(a) Resolving a perceived or actual conflict between existing requirements of IFRSs.

(b) Addressing an oversight or unintended consequence of the existing requirements of IFRSs.

A correcting amendment does not propose a new principle or a change to an existing principle. It may create an exception to an existing principle, for example an omitted consequential amendment from a recent change to an IFRS.

(b) The proposed amendment has a narrow and well-defined purpose, i.e., the consequences of the proposed change have been considered sufficiently and identified.

(c) It is probable that the IASB will reach agreement on the issue on a timely basis. An inability to reach agreement on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within **Annual Improvements**.

(d) If the proposed amendment is to IFRSs that are the subject of a current or planned IASB project, there is a pressing need to make the amendment sooner.

5. In the staff's opinion, the issue in the request does not satisfy the above proposed *Annual Improvements* criteria:

(a) Paragraph 69(d) of IAS 1 provides specific guidance on the classification of a liability as a 'current liability' when the entity does not have the unconditional right to defer settlement of the liability for at

least twelve months after the reporting period. Therefore, in the staff's opinion no clarification or correction is necessary.

(b) In the staff's opinion, a change to the principle of an unconditional right to defer settlement for at least twelve months after the reporting period may significantly impact the current vs non-current classification of all liabilities. Therefore, a change to this principle is not narrow.

(c) The staff is unsure as to whether the Committee would be able to reach agreement in a timely basis given the potentially significant impact to the classification of all liabilities.

(d) There is no current or planned project to review the distinction between current vs non-current classification of liabilities.

Staff recommendations

6. The staff has the following views:

(a) The staff agrees with the majority view expressed in the HKICPA analysis. In the staff's opinion, the majority view of the HKICPA is the only acceptable interpretation of the current wording in IAS 1.

(b) In the staff's opinion, the Committee's agenda criteria as stated in paragraph 24 of the *IFRIC Due Process Handbook* are not satisfied and this issue should not be added to the Committees agenda.

(c) In the staff's opinion, the draft criteria for *Annual Improvements* are not satisfied and this issue should not be recommended to the Board for addition to *Annual Improvements*.

7. Appendix B to this paper includes a staff prepared draft of the Tentative Agenda Decision consistent with the above staff recommendations.

Questions for the Committee

8. The staff requests the Committee answer the following questions:

Question 1 – Not to add to Committee agenda
Does the Committee agree with the staff recommendation not to add this issue to the Committee's agenda?

Question 2 – Not to recommend addition to *Annual Improvements*
Does the Committee agree with the staff recommendation not to recommend to the Board to add this issue to *Annual Improvements*?

Question 3 – Tentative Agenda Decision drafting
Does the Committee agree with the staff prepared draft of the Tentative Agenda Decision included in Appendix B to this paper?

Appendix A – HKICPA Request for Views

A1. The request from the Hong Kong Institute of Certified Public Accountants (HKICPA) included in its cover letter is copied below without modification. [NOTE: The ‘Appendix 1’ referenced in the last paragraph of the HKICPA cover letter has not been included as it is a non-public draft of the HKICPA.]

Current/non-current classification by the borrower of a term loan that is callable by the lender at anytime

The HKICPA Financial Reporting Standards Committee (FRSC) is currently considering an accounting issue related to whether the borrower of a term loan that is not repayable within twelve months after the reporting period, but may be callable by the lender at any time should be classified as a current or non-current liability.

<u>The issue</u>

In general, banks normally grant loans that are either demand loans (eg. loans that are repayable at any time at the discretion of the lender), or term loans (eg. loans that are repayable on specified dates 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.

IAS 1 *Presentation of Financial Statements* 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.”

It is clear from the standard that demand loans are classified as current liabilities because the borrower does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period since the lender may demand repayment at any time. Conversely, term loans that are not due to be settled within twelve months after the reporting date, and do not meet the other criteria described in IAS 1 paragraph 69, are classified as non-current liabilities.

However, we have encountered an issue in Hong Kong regarding the classification by the borrower of a term loan that contains a repayment on demand clause.

Typically, the loan agreements or loan facility agreements of term loans include payment terms, maturity date, and other provisions that are normally found in such facilities.

In addition to the provisions typically found in term loan agreements, some loan agreements or loan facility agreements also include a repayment on demand provision, which allows the lender to demand repayment at any time. Below are some examples of repayment on demand provisions that may be found in these latter loan agreements or loan facility agreements:

> "The facilities are subject to review at any time and also subject to the Bank's overriding right of withdrawal and repayment on demand, including the right to call for cash cover on demand for prospective and contingent liabilities."
>
> "By signing this letter, you expressly acknowledge that we 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."

We noted that there were cases where entities have classified 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. We understand that this classification was typically on the basis that the borrowers considered the risk of lenders exercising these clauses to be very low, except when the lender identified that there were events or changes in circumstances which might reasonably be expected to affect the borrower's ability to repay. The borrowers therefore approached these clauses in the same way as any covenant i.e. the clause would only result in a classification of the entire loan as current (all other things being equal) if such adverse matters relating to the borrower existed at the period end date. In all other situations (and assuming no other breaches of covenants) the borrower would classify the term loan as non-current to the extent that the scheduled repayments were due in more than twelve months.

Conclusion

The FRSC has discussed the matter with reference to paragraph 69 of IAS 1. In particular, the Committee noted that under paragraph 69(d) of IAS 1, an entity shall classify a liability as current when "it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period".

Majority view

The conclusion of the majority of the Committee was that under IAS 1.69(d) the classification of a term loan as a current or non-current liability should be determined by reference to the rights and obligations of the lender and the borrower, as contractually agreed between the two parties. In cases where the repayment on demand clause provides the lender with a clear and unambiguous right to demand repayment at any time at its sole discretion, notwithstanding any other terms and maturity stated in the agreement, the borrower should not be considered to have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Therefore, term loans with such repayment on demand clauses should be classified as current liabilities in their entirety, irrespective of the probability that the lender will exercise the clause.

Alternative view

Some of the Committee members questioned whether the current practice of treating these clauses in a manner similar to covenants (as described above) could also be an acceptable interpretation of paragraph 69 of IAS 1.

The supporters of this view argued that paragraph 69 of IAS 1 does not provide clear guidance that a term loan which contains a repayment on demand clause must be classified as current. Instead they noted the following:

- Paragraph 69(a) triggers a current liability classification when the borrowing entity "expects to settle" the liability in its normal operating cycle. This seems to require looking at expectations of the borrower's ability to repay and if he expects to settle within twelve months, the liability is classified as current even if the borrower is not obliged to pay until after twelve months. The scheduled loan repayment timetable is therefore superseded by the ability and intention of the borrower to repay early. This introduces the need to look at the substance of the timing of the repayment and not just the legal repayment schedule or legal obligation. It is believed that the purpose of disclosing current and non-current liabilities separately is to show when the cash outflows are expected to happen. Arguably, unless the lender has exercised his right to require immediate repayment, the expected cash flows should follow the agreed schedule of repayments and to disclose otherwise would be misleading. The maturity analysis required under IFRS 7 could be regarded as a separate issue meeting a different purpose.

- Paragraph 69(c) requires amounts due to be settled within twelve months to be regarded as current. However, it is not clear how this requirement should be applied in the situation of a term loan that is repayable on demand. It could be argued that a schedule of repayments sets out when a term loan is "due to be settled" and therefore, if the scheduled settlement dates are beyond twelve months after the reporting date then paragraph 69(c) would require the loan to be classified as non-current.

- Paragraph 69(d) requires a liability to be regarded as current when the borrower does not have an unconditional right to defer settlement for at least twelve months after the reporting period. Importantly, there is an immediate reference to paragraph 73 in paragraph 69 and the intention, it appears, is to give context in which paragraph 69(d) is to be applied. Notably, it refers to specific circumstances, namely, where the borrower has the discretion to roll over or extend the obligation. If the borrower has the discretion, the liability can be classified as non-current but where the borrower does not have the discretion or the discretion is in the hands of the lender, the liability is classified as current. It is argued that paragraph 69(d) is intended to address situations where there is a discretion held by the borrower to enable it to roll over the loan and that paragraph 69(d) was not intended to address situations such as loans containing repayment on demand clauses.

- Further, paragraph 74 continues that if the borrower breaches a provision of a long term loan arrangement before the year end, the liability becomes payable on demand. Therefore there is a trigger for re-classifying a long term payable to a current liability. It is believed that a similar argument for a trigger could be made for term loans which include rights to demand immediate repayment by lenders. It is arguable for these to be regarded as non-current and that they only become current when the trigger is activated, that is, when the lender exercises his right to make the loan repayable immediately. In the absence of the trigger being activated, the loan is still non-current.

Request for views on proposed local interpretation

--- To address this issue, the FRSC has drafted a proposed local interpretation attached at **Appendix 1** based on the majority view of the Committee. However, before issuing this and in accordance with the HKICPA's convergence due process, it would be much appreciated if we could receive your comments **before 30 August** on whether you consider that the alternative view has sufficient basis to warrant formally submitting a request to add this issue to the IFRS Interpretations Committee's agenda or whether you agree with the majority of the Committee that our proposed local interpretation is the only acceptable interpretation under the current wording in IAS 1.

Appendix B – Staff draft of proposed Tentative Agenda Decision

A2. Below is a staff prepared draft of the Tentative Agenda Decision consistent with the staff recommendations included in this paper.

> **IAS 1 *Presentation of Financial Statements* – Current/ non-current classification of callable term loan**
>
> The IFRS Interpretations Committee received a request on the classification of a liability as current or non-current when the liability is not repayable within twelve months after the reporting period, but may be callable by the lender at any time.
>
> The Committee notes that paragraph 69(d) of IAS 1 requires that a liability be classified as a current liability if the entity does not have the unconditional right to defer settlement for at least twelve months after the reporting period.
>
> The Committee noted that IAS 1 provides sufficient guidance on the presentation of liabilities as current or non-current and that it does not expect diversity in practice. Therefore, the Committee [decided] not to add the issue to its agenda.