

IFRS/HKFRS News Supplement

In this newsletter:

1. HKICPA issues HK Interpretation 5 “Presentation of Financial Statements – Classification by the Borrower of a Term Loan that contains a Repayment on Demand Clause”
2. Contacts

HKICPA issues HK Interpretation 5 “Presentation of Financial Statements – Classification by the Borrower of a Term Loan that contains a Repayment on Demand Clause”

What is the issue?

The IFRS Interpretations Committee (the “IFRIC”) at its meeting in November 2010 confirmed its conclusion that a liability, which may be callable by the lender at any time without cause (an overriding right of demand), must be classified as a current liability in accordance with paragraph 69(d) of IAS 1. The HKICPA issued HK Interpretation 5, “Presentation of Financial statements – Classification by the Borrower of a Term Loan that contains a Repayment on Demand Clause” about the same matter under HKFRS.

IFRIC decided that IAS 1 is already clear on this issue and its conclusion has immediate effect for financial statements prepared under IFRS. For financial statements prepared under HKFRS, HK Interpretation 5 is also effective immediately since it is a clarification of an existing standard.

The rest of this article focuses on the application of HK Interpretation 5 as applied under HKFRS.

Key provisions

The classification of a term loan depends on whether or not the borrower has an unconditional right to defer payment for at least 12 months after the reporting period. Consequently, any clauses that give the lender the unconditional right to call the loan at any time will lead to a current classification in the borrower’s statement of financial position of the amount of the loan. In this regard, the probability



of the lender choosing to exercise its rights within the next 12 months after the reporting date is not relevant. HKICPA provided four examples of such clauses in its Q&As which, in accordance with HK Interpretation 5, would result in classification of the term loan as a current liability (refer to Appendix).

On the other hand, loan agreements typically contain an extensive list of “events of default” which, if they occur, would entitle the lender to demand immediate repayment. The classification of these type of “event of default” clauses are governed by paragraphs 74 to 75 of HKAS 1, which the term loan is classified 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. HKICPA also provided examples of subjective “events of default” clauses which generally would not result in classification of the term loan as a current liability (refer to Appendix).

Since the issuance of this interpretation, borrowers have been seeking “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 clause would not be classified as current liabilities in the financial statements. HKICPA did not provide any standard wording to be followed since the condition a lender is prepared to lend is a matter to be agreed by the borrower and 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) during the period as stated in 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 (refer to “events of default” wording in Appendix).

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.

Am I affected?

This type of callable feature has been found to be particularly prevalent in agreements governing borrowing facilities provided by banks in Hong Kong. However, it has been noted that borrowers in the PRC, Singapore and Taiwan are exposed to such a feature through bank loans and syndicated loans involving local and foreign banks and variants may also be found in borrowing facilities granted by banks in other their jurisdictions, e.g. PRC.

What do I need to do?

- Entities are urged to review contractual terms of all the loan agreements, including syndicated loans, banking facilities letters as well as covering letters and side letters entered together with loan agreements to identify any term loans with the callable feature.
- If such callable feature exists and the loan has been classified based on the repayment terms historically, entities should discuss with the banks as to whether such a callable feature

can be removed from the loan agreements or facilities, or whether the banks will modify the conditions. Any modification by the bank must be more than just an expression of intent not to use the call feature and must be a legally binding amendment to the loan agreement or facility. The modification should be in place before the entity’s balance sheet date. That is before 31 December 2010 for calendar year-end companies.

- The entities need to consider the accounting implication on comparatives resulted from the negotiation with the bank, based on the specific facts and circumstances.
- Entities also need to consider other matters such as breach of covenants on bank loans and other facilities; disclosure of price sensitive information for companies listed on HK stock exchange and effect of reproduction of issued financial statements. Please refer to Q8 of the Q&A for further explanations.
- For “comfort letters” obtained prior to balance sheet date covering only 12 months from the balance sheet date, entities will need to obtain updated “comfort letters” for every reporting period including interim report.
- If you have any questions about this issue, please contact your PwC engagement partner.

Appendix: Please note the following are extract from Q&A issued by HKICPA. The Q&A can be accessed via the following link.

http://www.hkicpa.org.hk/file/media/section6_standards/standards/FinancialReporting/rm/2010/QA%20hkint5.pdf

Commonly asked questions regarding the application of HK Interpretation 5

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?

A3: 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 in the Q&As 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 collateralisation 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”

Contacts

For further help, please contact:

Hong Kong

22/F, Prince's Building
Central, Hong Kong
Tel: +852 2289 8888

Beijing

26/F, Office Tower A
Beijing Fortune Plaza
7 Dongsanhuan Zhong Road
Chaoyang District
Beijing 100020, PRC
Tel: +86 (10) 6533 8888

Shanghai

11/F, PricewaterhouseCoopers
Center, 2 Corporate Avenue
202 Hu Bin Road
Luwan District
Shanghai 200021, PRC
Tel: +86 (21) 2323 8888

Chongqing

Room 1905
19/F Metropolitan Tower
68 Zou Rong Road
Chongqing 400010, PRC
Tel: +86 (23) 6393 7888

Dalian

8/F, Senmao Building
147 Zhongshan Road
Xigang District
Dalian 116011, PRC
Tel: +86 (411) 8379 1888

Guangzhou

18/F, PricewaterhouseCoopers
Center, 10 Zhujiang Xi Road
Pearl River New City
Tianhe District
Guangzhou 510623, PRC
Tel: +86 (20) 3819 2000

Macau

29/F
Bank of China Building
323 Avenida Doutor Mario
Soares, Macau
Tel: +853 8799 5111

Ningbo

Room 202, Tower C
(Sheraton Ningbo Hotel)
Portman Plaza
50 Caihong Road North
Jiangdong District
Ningbo 315040, PRC
Tel: +86 (574) 8773 6888

Qingdao

4601 Qingdao
International Finance Center
59 Hong Kong Middle Road
Qingdao 266071, PRC
Tel: +86 (532) 8089 1888

Shenzhen

38/F, Shun Hing Square
Di Wang Commercial Centre
5002 Shennan Road East
Shenzhen 518008, PRC
Tel: +86 (755) 8261 8888

Singapore

8 Cross Street #17-00
PWC Building
Singapore 048424
Tel: +65 6236 3388

Suzhou

Room 1501
Genway Tower
188 Wang Dun Road
Suzhou Industrial Park
Suzhou 215028, PRC
Tel: +86 (512) 6273 1888

Taiwan

27/F, International
Trade Building
333 Keelung Road
Section 1, Taipei
Taiwan 110
Tel: +886 (2) 2729 6666

Tianjin

17/F, The Exchange
Tower One
189 Nanjing Road
Heping District
Tianjin 300051, PRC
Tel: +86 (22) 2318 3333

Xiamen

Unit B
11/F International Plaza
8 Lujiang Road
Siming District
Xiamen 361001, PRC
Tel: +86 (592) 210 7888

Xi'an

Room 728
Zhongda International
Mansion
30 Nan Da Street
Xi'an 710002, PRC
Tel: +86 (29) 8720 3336

This publication has been prepared by PwC for general guidance on matters of interest only, and is not intended to provide specific advice on any matter, nor is it intended to be comprehensive. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PwC firms do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it. If specific advice is required, or if you wish to receive further information on any matters referred to in this publication, please speak with your usual contact at PwC or those listed in this publication.

