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# FASB Reexposes Proposed ASU on Simplification of the Balance Sheet Classification of Debt

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## Introduction

On September 12, 2019, the FASB issued a [proposed ASU](#)<sup>1</sup> aimed at reducing the cost and complexity of determining whether debt should be classified as current or noncurrent in a classified balance sheet. The new proposed ASU represents a revised version of the proposed ASU on the same topic that was issued on January 10, 2017. The FASB decided to clarify and reexpose its proposed approach in response to feedback received on an entity's evaluation of long-term financing agreements and grace periods in its classification of debt as current or noncurrent. Comments on the proposed ASU are due by October 28, 2019.

## Overview of Proposed Changes

### Background

The FASB has received feedback from stakeholders indicating that the existing guidance on the balance sheet classification of debt is unnecessarily complex. The current guidance in ASC 470-10<sup>2</sup> consists of an assortment of fact-specific rules and exceptions, the application of which varies depending on multiple factors. The Board's proposed approach would replace the current, fact-specific guidance with a uniform principle for determining debt classification. In addition, the proposed ASU includes application guidance that would clarify how covenant violations, covenant waivers, post-balance-sheet refinancing transactions, and subjective acceleration clauses (SACs) affect debt classification.

<sup>1</sup> FASB Proposed Accounting Standards Update (ASU), *Debt (Topic 470): Simplifying the Classification of Debt in a Classified Balance Sheet (Current Versus Noncurrent)*.

<sup>2</sup> For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte's "[Titles of Topics and Subtopics in the FASB Accounting Standards Codification](#)."

## **Proposed Changes**

### ***Scope***

The proposed debt classification guidance would apply to all entities that enter into debt arrangements, including debt securities, loan agreements, and revolving credit arrangements. Under the proposed ASU, a debt arrangement would be defined in the ASC master glossary as an “arrangement that provides a lender with a contractual right to receive consideration and a borrower with a contractual obligation to pay consideration on demand or on fixed or determinable dates.” Such arrangements would also include (1) financial instruments in the legal form of shares that are presented as liabilities because they meet the definition of mandatorily redeemable financial instruments in ASC 480, (2) convertible debt instruments within the scope of ASC 470-20, and (3) lease liabilities within the scope of ASC 840 and ASC 842. However, the proposed ASU would not affect an entity that does not present a classified balance sheet.

### ***Classification Principle***

In place of the current, fact-specific guidance in ASC 470-10, the proposed ASU would introduce a classification principle under which a debt arrangement would be classified as noncurrent if either (1) the “liability is contractually due to be settled more than one year (or operating cycle, if longer) after the balance sheet date” or (2) the “entity has a contractual right to defer settlement of the liability for a period greater than one year (or operating cycle, if longer) after the balance sheet date.”

Under the proposed classification principle, which focuses on a debt arrangement's contractual terms as of the balance sheet date, some liabilities that are classified as noncurrent under existing U.S. GAAP would be classified as current, and other liabilities that are classified as current under existing U.S. GAAP would be classified as noncurrent. The proposed debt classification principle implies that debt that is not contractually due to be settled within 12 months of the balance sheet date generally would be classified as noncurrent even if the debtor expects to settle the debt within that period. Unlike existing GAAP, this principle would apply even if the borrower violates — or is expected to violate (e.g., because of recurring losses or liquidity problems) — a debt covenant after the balance sheet date. In addition, if a borrower violates a provision of a long-term debt arrangement as of the balance sheet date and the debt arrangement provides a specified grace period for the debtor to become compliant before the creditor can demand repayment, the debt would be classified as noncurrent if either of the two criteria in the principle are met. Under existing guidance, that debt arrangement would be classified as current unless it is determined to be probable that the violation would be cured within the grace period. Further, under the proposed ASU, long-term debt subject to an SAC would be classified as noncurrent if the borrower has received no notification from the lender that it is in noncompliance with the clause as of the balance sheet date regardless of whether there has been a change in circumstances that would reasonably be expected to permit the SAC to be invoked. The special classification guidance under current U.S. GAAP that applies to debt arrangements with SACs would be eliminated.

Conversely, the proposed ASU would classify debt as current if it is contractually due to be settled within 12 months of the balance sheet date (e.g., because of an objectively determinable debt covenant violation as of the balance sheet date, provided that the covenant waiver exception described below does not apply). Under the proposed guidance, short-term debt would be classified as current even if the entity expects to refinance it under a long-term financing agreement, while under existing GAAP, the presence of a long-term financing agreement would have resulted in noncurrent classification of the short-term debt if certain criteria were met.

## Covenant Waiver Exception

Under an exception to the proposed classification principle, an entity would not classify debt as current solely because of a debt covenant violation that gives the lender the right to demand repayment of the debt, as long as the lender waives its right before the financial statements are issued (or are available to be issued). For debt to qualify for this exception, the following conditions would have to be met:

- The waiver is for a period greater than one year (or operating cycle, if longer) after the balance sheet date.
- The waiver does not result in a modification that would be accounted for as a debt extinguishment under ASC 470-50 or a troubled debt restructuring under ASC 470-60.
- It is not probable that any other covenants in the debt arrangement will be violated within 12 months (or operating cycle, if longer) from the balance sheet date.
- The debt would have qualified for classification as noncurrent as of the balance sheet date in the absence of the covenant violation.

In addition, entities would be required to separately present the amount of debt that is classified as noncurrent as a result of the waiver exception on the face of a classified balance sheet.



### Connecting the Dots

Although there is already a covenant waiver exception under current U.S. GAAP, the proposal to require entities to separately present the amount of debt that is classified as noncurrent as a result of this exception is new.

The example below illustrates how the balance sheet presentation of noncurrent debt attributable to the covenant waiver exception would change under the proposed ASU.

#### Example

As of December 31, 2018, Entity A has \$100 million in outstanding long-term debt obligations. Of the \$100 million, \$35 million is in default as of the balance sheet date. However, before A filed its financial statements, it received a waiver of the amount in default.

While the proposed ASU would retain the covenant waiver exception so that A would present the \$35 million within noncurrent liabilities when certain conditions are met, it would require A to separately present the amount of debt that is classified as noncurrent as a result of the waiver exception (i.e., the \$35 million). Examples of balance sheet presentations under current U.S. GAAP and the proposed ASU are shown below.

Balance Sheet Presentation (Current U.S. GAAP)		Balance Sheet Presentation (Proposed ASU)	
Noncurrent debt	\$ 100,000,000	Debt classified as noncurrent because of waivers obtained after the balance sheet date	\$ 35,000,000
		Other noncurrent debt	\$ 65,000,000

## **Refinancing of Short-Term Obligations**

The proposed ASU would change the classification of short-term obligations that an entity expects to refinance on a long-term basis (e.g., under a letter of credit, line of credit, or other long-term financing agreement). Under current U.S. GAAP, short-term obligations are classified as noncurrent if an entity has the intent and ability to refinance the obligation on a long-term basis, as demonstrated by either (1) the issuance of a long-term obligation or equity securities after the balance sheet date or (2) a financing agreement that clearly permits the entity to refinance on a long-term basis. In contrast, the proposed ASU would prohibit an entity from considering refinancing transactions that occur after the balance sheet date. Therefore, short-term obligations would be classified as current even if the entity intends and has the ability to refinance them on a long-term basis.



### **Connecting the Dots**

In discussions of the feedback received on the initial proposed ASU, the FASB considered alternative approaches under which an entity would have been required to consider some or all unused long-term financing agreements in the classification of debt as current or noncurrent. Under those approaches, short-term debt would have been classified as noncurrent if the entity had qualifying long-term financing arrangements (e.g., on the basis of a contractual linkage between debt and long-term financing agreements in place as of the balance sheet date). However, the FASB ultimately decided to reject such approaches in part due to their cost and complexity.

Entities should consider the timing of refinancing plans and the potential effect on the classification of short-term obligations.

## **Convertible Debt**

In the Background Information and Basis for Conclusions of the proposed ASU, the Board suggests that an entity should classify convertible debt on the basis of when the liability is contractually due to be settled in cash or other assets as opposed to when that debt may be converted to equity. If a debt agreement contractually stipulates that settlement must occur entirely in shares, an entity would determine the classification on the basis of when the liability is contractually due regardless of the settlement form.

## **Disclosures**

The proposed ASU would require an entity to disclose the following information about any event of default (e.g., a loan covenant violation or a notification from a lender that an SAC has been triggered) “[i]n the period in which [the] event of default occurs . . .

- a. An explanation of the default
- b. The amount of obligations subject to the default
- c. The terms of a waiver (including period of the waiver, if applicable).”

The following additional disclosures would be required in “the period in which an entity violates a provision of a long-term debt arrangement and the debt arrangement provides a grace period that expires after the balance sheet date [if] that violation has not been cured before the financial statements are issued (or [are] available to be issued) and the failure to cure the violation would give the lender the right to demand payment of the long-term debt arrangement when the grace period expires:

- a. An explanation of the violation
- b. The amount of obligations subject to the violation
- c. The terms of the grace period.”

## Effective Date and Transition

The FASB will determine an effective date for the final guidance after the proposal's comment period.

The proposed ASU would become effective in the first annual period after its effective date (including interim periods within that annual period). An entity would be required to apply the guidance in the proposed ASU prospectively to all debt that exists as of the new standard's date of initial adoption and after that date. In addition, under the proposed guidance, "[a]n entity is required to [provide the following transition disclosures]:

1. The nature of and reason for the change in accounting principle
2. The effect of the change on the affected financial statement line items in the current period."

Early adoption of the proposed amendments would be permitted.

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