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Heads Up | Volume 24, Issue 1

January 12, 2017

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FASB Proposes Changes to Simplify the Balance Sheet Classification of Debt

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Introduction

On January 10, 2017, the FASB issued a proposed ASU[1] aimed at reducing the cost and complexity of determining whether debt should be classified as current or noncurrent in a classified balance sheet. Comments on the proposal are due by May 5, 2017.

This *Heads Up* provides an overview of the proposed changes.

Overview of Proposed Changes

Background

The FASB has heard from stakeholders that the existing guidance on the balance sheet classification of debt is unnecessarily complex. The current guidance in ASC 470-10[2] consists of an assortment of fact-specific rules and exceptions, the application of which varies depending on multiple factors. The FASB's proposed approach would replace the current, fact-specific guidance with a uniform principle for determining debt classification. In addition,

[1] FASB Proposed Accounting Standards Update, *Simplifying the Classification of Debt in a Classified Balance Sheet (Current Versus Noncurrent)*.

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

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.

Proposed Changes

Scope

The proposed ASU would apply to all entities that enter into debt arrangements, including debt securities, loan agreements, and revolving credit arrangements. It would define a debt arrangement 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." In addition, the proposal would amend the scope of ASC 470-10 to specifically 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 and (2) convertible debt instruments within the scope of ASC 470-20. 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 at least one year (or operating cycle, if longer) after the balance sheet date."

Editor's Note

Under the proposed classification principle, 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. For example, the special classification guidance under current U.S. GAAP that applies to debt arrangements with SACs would be eliminated.

The proposed debt classification principle implies that debt that is not contractually due to be settled within 12 months of the reporting date generally would be classified as noncurrent 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. Further, 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.

Conversely, debt would be classified as current if it is contractually due to be settled within 12 months of the balance sheet date (e.g., as a result of the occurrence of an objectively determinable debt covenant violation as of the balance sheet date, assuming that the covenant waiver exception described below does not apply).

Covenant Waiver Exception

Under an exception to the classification principle, an entity would not classify debt as current solely because of the occurrence 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).
- 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.

Editor's Note

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, 2016, 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. 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 that the entity expects to refinance on a long-term basis would be classified as current.

Editor's Note

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

Disclosures

The proposed ASU would require an entity to disclose the following information about any events of default (e.g., a loan covenant violation or trigger of an SAC):

a. An explanation of the deficiency
b. The amount of obligations subject to the default
c. The terms of a waiver (including period of the waiver, if applicable)
d. A description of the course of action that the entity has taken, or that it proposes to take, to remedy the deficiency.

Effective Date and Transition

The FASB will determine an effective date for the final guidance after the end of 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. In addition, an entity would be 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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