Wolters Kluwer

GAAP UPDATE SERVICE

Volume 17, Issue 19 October 15, 2017

PROPOSED PRONOUNCEMENT: Debt (Topic 470): Simplifying the Classification of Debt in a Classified Balance Sheet (Current versus Noncurrent) (Exposure Draft Issued January 2017)

EFFECTIVE DATE: This proposal has not been finalized.

Summary & Highlights

The FASB's proposal is intended to simplify the rules that determine whether debt should be classified as current or noncurrent. If finalized as proposed, the new guidance on debt classification would replace the current hodgepodge of rules based on varying criteria with a principle based on the debt's legal terms. The proposal could affect companies that present a classified balance sheet (i.e. current assets and liabilities separated from long-term assets and liabilities). Some believe that more debt will be classified as current if the standard is finalized as proposed.

The most common fact patterns affected by the proposal are:

- *Waivers of debt covenant violations received before the financial statements are issued:* The proposed guidance would continue to classify debt as long-term when a company receives a waiver for a covenant violation prior to issuing its financial statements. However, the balance sheet would separately report debt classified as noncurrent as a result of a waiver.
- *Short-term debt refinanced on a long-term basis after the balance sheet date but before the financial statements are issued:* Under the proposed guidance, a company with this fact pattern would be required to classify the short-term debt as a current liability.
- *Debt arrangements with a subjective acceleration clause or a material adverse change clause:* The proposed guidance would eliminate the need to assess the probability of acceleration as a result of these types of clause when determining the debt's classification. Debt would not be reclassified as a current liability until the clause is triggered.

The FASB received 29 comment letters on its proposal. Most of the comments were from audit firms and professional organizations of accountants. A handful of public companies also provided comments. The feedback was mixed. While 36% of the respondents believe the proposal would simplify the classification guidance without diminishing the usefulness of the reported information, 40% disagreed (the remaining 24% expressed conditional support.) No comments were received from investors, lenders, regulators or other users of financial statements.

The Board began to re-deliberate its proposed guidance in June 2017 and has asked the staff to conduct additional outreach and research. The FASB has not indicated when it might issue a final standard.

Analysis and Implementation

Objective and Background

This proposal was issued as part of the FASB's ongoing Simplification Initiative. Created in 2014, the initiative is a response to concerns that GAAP has become unnecessarily complex. As part of its initiative, the FASB is targeting specific, narrow issues that could reduce the cost and complexity of existing rules without diminishing the usefulness of the financial statements.

In the past few years, the FASB has issued nearly a dozen new standards under the "simplification" rubric. Examples include eliminating the concept of extraordinary items from the income statement and changing the presentation of debt issuance costs to be consistent with the presentation of a debt discount or premium.[1]

The topic "balance classification of debt" was considered ripe for simplification because the existing accounting guidance is essentially a series of unrelated rules that vary based on the fact pattern or based on the type of debt. Existing GAAP has separate guidance for callable debt, debt due on demand, and debt with lockboxes. Some guidance is based on a specific fact pattern, such as the waiver of a covenant violation or the refinancing of debt shortly after the balance sheet date. And the guidance is not always consistent. In some situations the guidance focuses on management's expectations regarding the timing of debt payments while in other situations the guidance looks to the terms of the debt agreement. These varying conclusions and rationales make it difficult to determine the appropriate accounting for fact patterns that are not explicitly addressed in the literature.

By proposing a principle for classification that is based on the legal terms of the debt, the Board believes it can simplify the accounting literature and thereby reduce the costs of complying with GAAP.

Principal Changes (Proposed)

The proposal is focused exclusively on the presentation of debt in a balance sheet that separates current assets and liabilities from long-term (noncurrent) amounts. It does not propose any changes to the accounting for debt, debt issuance costs, debt discounts or premiums, or interest expense.

The proposal would apply to all debt arrangements, including convertible debt and mandatorily redeemable financial instruments classified as liabilities.

Under the proposal, classification would be based on the following principle:

> Debt is noncurrent if, at the balance sheet date:
>
> (a) The liability is contractually due to be settled more than one year after the balance sheet date, OR
> (b) The company has a contractual right to defer settlement of the liability for at least one year after the balance sheet date.

This proposed principle focuses on the legal rights under the debt agreement at the balance sheet date (e.g. at the end of a company's quarter or fiscal year.) Under that principle, events that occur after the date of the balance sheet would not be considered when determining the classification of debt. Examples of subsequent events include:

- waivers of loan covenant violations,
- events of default,
- refinancing (including modifications that, for accounting purposes, represent the extinguishment of the existing loan and the issuance of new debt), and
- triggering a subjective acceleration or material adverse change clause.

With one important exception (for waivers obtained after the balance sheet date, as discussed below), the proposal would require companies to ignore subsequent events when determining the debt's classification.

The following paragraphs discuss several common subsequent events and how they would be treated under the FASB's proposal.

<u>*Subsequent Event: Waivers*</u>—As proposed, if (a) the waiver is for a period greater than one year from the balance sheet date, (b) the waiver does not result in a modification that is either an extinguishment or a troubled debt restructuring, *and* (c) management does not believe it is probable that other covenants will be violated within 12 months from the balance sheet date, the company would classify the debt as noncurrent, assuming the debt otherwise meets the principle.[2]

A waiver that is issued *prior to* the balance sheet date represents legal rights that exist at the balance sheet date and therefore would require no exception. However, when there is a covenant violation at quarter or year end, as a practical matter, companies typically are unable to obtain a waiver until *after* the balance sheet date. Therefore, the FASB is proposing an exception to its principle that would result in accounting that is similar to existing GAAP. [3] Unlike existing GAAP, however, the proposed standard would require the amount of debt that is classified as noncurrent due to a waiver to be presented as a separate line item in the balance sheet.

The FASB considered whether to address the accounting for fees paid in conjunction with waivers but concluded that it would not amend GAAP to require companies to accrue such fees.

EXAMPLE: PROPOSED ACCOUNTING GUIDANCE

Waiver of Debt Covenant Violation[4]

Company XYZ has a $5 million term loan from a bank.The term loan, which is due in 2024, contains financial covenants. Specifically, the bank can demand repayment of the loan if the current ratio falls below 2 to 1 or if shareholders' equity falls below $16 million. Compliance with these financial covenants is required at the end of every quarter. Company XYZ also has $3 million of other borrowings due in 2026 through 2028. Those other borrowings have a similar shareholders' equity financial covenant but no other financial covenants and no cross-default provisions.

In preparing the preliminary draft of Company XYZ's year-end December 31, 2020 financial statements, management determines that stockholders' equity is $22 million but the current ratio is 1.8 to 1. The violation of the current ratio covenant in the term loan is an event of default that allows the bank to demand repayment of the term loan. On January 24, 2021, prior to issuing its December 31, 2020 annual financial statements, Company XYZ obtains a written waiver from the bank stating that the bank waives its right to demand payment of the term loan for this specific violation for 15 months. The waiver letter further states that the bank retains its rights under the shareholders' equity financial covenant. There is no change to the interest rate, duration of the loan or other terms of the loan agreement. The bank does not charge a fee for issuing the waiver.

Company XYZ determines that it meets the proposed criteria for classifying the term loan as long-term as of December 31, 2020 because: (a) the loan would have been classified as current absent the covenant violation, (b) the waiver was obtained before the financial statements were issued, (c) the waiver is for a period greater than one year after the balance sheet date, (d) the waiver did not result in an extinguishment or a troubled debt restructuring, and (e) based on its current amount of shareholders' equity and the forecast for 2021, management does not believethat Company XYZ will violate the minimum shareholders' equity covenant through December 31, 2021 (12 months from the balance sheet date.)

Company XYZ presents the following line items in the long-term liability section of its December 31, 2020 balance sheet:

Term loan classified as long-term due to a waiver	$5,000,000
Other long-term debt	3,000,000
Deferred tax liabilities	410,000
Other long-term liabilities	235,000
Total long-term liabilities	$8,645,000

Company XYZ also complies with the proposal's footnote disclosure requirements.

Subsequent Event: Covenant Violation—A covenant violation that occurs after the balance sheet date would not affect the debt's classification in the financial statements, even if the covenant violation is identified before the financial statements are issued. That outcome is consistent with the proposed principle because the debt's classification is based on contractual rights at the balance sheet date. This aspect of the proposed standard would not represent a change from existing GAAP.

Subsequent Event: Refinancing—Perhaps the most significant change proposed by the FASB relates to fact patterns in which short-term debt is either refinanced on a long-term basis or is repaid by the issuance of equity securities after the balance sheet date but before the financial statements are issued. Under the proposed guidance, a company would be required to classify the short-term debt as a current liability regardless of how the refinancing is structured. Whether the refinancing represents new debt with a new lender, new debt with the same lender, a modification of existing debt with the same lender, or repayment of debt using proceeds from the issuance of equity securities ,the contractual terms of the debt dictate its classification.

Subsequent Event: Trigger of Subjective Acceleration/Material Adverse Change Clause—Debt arrangements that include a subjective acceleration clause or a material adverse change clause also would be affected by the proposal. Existing GAAP requires companies to consider the likelihood of acceleration under these types of clauses when classifying the debt as current or noncurrent. The proposal would remove that probability assessment so that the debt is not reclassified until the clause is triggered.

Proposed Disclosures—The proposal would require companies to disclose specific information when there is an event of default (i.e. the violation of a loan covenant or trigger of a subjective acceleration or material adverse change clause). Specifically, the company should explain the deficiency, the amount of obligations subject to the default, the terms of any waiver that has been obtained, and the course of action that the company has taken, or that it plans to take, to remedy the deficiency.

Companies Likely to be Affected by the Proposal (Private and public companies would be similarly affected)

Because public companies must comply with reporting deadlines established by securities laws, a public company that identifies an event of default at the end of an interim or annual period has a narrow window within which to obtain a waiver. As discussed above, absent a qualifying waiver received prior to the issuance of financial statements, debt in default is classified as current if the default provides the lender with the right to accelerate repayment. While a private company is not constrained by securities law deadlines, it may be contractually obligated under its debt agreement to issue financial statements within a certain number of days after the end of a quarter or year.

The proposed disclosures would not be burdensome for either public or private companies.

Proposed Effective Date and Transition

The effective date will be determined after the FASB considers feedback from constituents and redeliberates its proposal. However, the Board has indicated that it would permit early adoption.

For transition purposes, the FASB would require prospective implementation. Under that approach, the new classification and disclosure requirements would be implemented by a company in its first set of interim or annual financial statements following the standard's effective date.

Recent Developments in GAAP

This section of the GAAP Update provides insight into recent decisions by the FASB and alerts you to recently issued new standards and exposure drafts plus other developments that are in the pipeline.

Exposure Drafts

- **Leases and Land Easements — Transition Practical Expedients —**This project addresses questions about the effect of the new lease standard on land easements. The FASB is expected to release an exposure draft that, if finalized, would provide companies with a practical expedient when adopting the new lease standard. Specifically, the proposal would permit companies to grandfather their current accounting policies for land easements that exist at the date the new lease standard is adopted. The new lease standard will have to be considered only for land easement arrangements that are modified or entered into after the lease standard is adopted. *An exposure draft is scheduled to be released in the third quarter of 2017*.

Other

- **SEC: Confidential Filings for Initial Public Offerings —**The SEC staff announced that, effective July 10, 2017, all companies, regardless of size, are permitted to make confidential submissions of draft registration statements for an initial public offering.
- Previously, only a company that qualified as an "emerging growth company" (ECG)[5] was permitted to submit its draft filing confidentially. Consistent with the requirements of an ECG, a company requesting a confidential review must confirm that it will publicly file its registration statement and nonpublic draft submissions at least 15 days prior to any road show. (In the absence of a road show, the information must be submitted at least 15 days prior to the requested effective date of the registration statement.)[6] [7]
- The SEC staff also issued a Q&A stating that a company filing a draft registration statement may omit from the draft any interim and annual financial information that it reasonably believes will not be required at the time it publicly files its registration statement.[8]

Endnotes

[1] The FASB website lists the completed projects resulting (to date) from the Simplification Initiative. http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176164432588.

[2] If the waiver would result in a troubled debt restructuring or a debt extinguishment, the exception would not apply. A debt extinguishment or a troubled debt restructuring is akin to the issuance of new debt.

[3] International Financial Reporting Standards (IFRS) prohibits companies from considering a waiver granted after the balance sheet date. Refer to IAS 1, *Presentation of Financial Statements*. Thus US GAAP and IFRS would continue to differ.

[4] This example is derived from Case A: Debt Is Classified as Noncurrent in paragraphs 470-10-55-3 through 55-3B in the proposed ASU.

[5] Under securities laws, an "emerging growth company" must have total annual gross revenues of less than $1 billion during its most recently completed fiscal year. That dollar amount was set in 2012 under the "Jumpstart Our Business Startups (JOBS) Act" and is adjusted for inflation every five years. In April 2017, the revenue cutoff was revised to $1.07 billion.

[6] Consistent with its practice in all filing reviews, the SEC staff publicly releases its comment letters and issuer responses to staff comment letters on EDGAR no earlier than 20 business days following the effective date of a registration statement.

[7] For more information, see the FAQS from the SEC's Division of Corporation Finance at *https://www.sec.gov/corpfin/voluntary-submission-draft-registration-statements-faqs*. Also see the SEC staff announcement at *https://www.sec.gov/corpfin/announcement/draft-registration-statement-processing-procedures-expanded#_ftn3*.

[8] This announcement was made in August. Refer to Q&As 101.04 and 101.05 in the SEC Division of Corporation Finance Compliance and Disclosure Interpretations at *https://www.sec.gov/divisions/corpfin/guidance/safinterp.htm#20101.04*.

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