The proposal would replace today’s rules-based guidance with a principles-based approach.

What you need to know

- The FASB proposed replacing today’s rules-based guidance for determining whether to classify debt as current or noncurrent on the balance sheet with a principles-based approach.
- Debt would be classified as noncurrent only when it is contractually due to be settled more than one year (or operating cycle, if longer) after the balance sheet date or when the entity has a contractual right to defer settlement for at least one year (or operating cycle, if longer) after the balance sheet date.
- While this approach would require entities to classify debt based on legal rights existing at the balance sheet date, an exception would be provided for waivers of debt covenant violations received after the balance sheet date but before the financial statements are issued.
- Entities would no longer be able to consider their intent and ability to refinance short-term obligations after the balance sheet date on a long-term basis to support noncurrent classification.
- Comments are due by 5 May 2017.

Overview

The Financial Accounting Standards Board (FASB) proposed replacing today’s rules-based guidance on debt classification in Accounting Standards Codification (ASC) 470-10-45 with a cohesive principle for determining whether debt should be classified as current or noncurrent on the balance sheet. The proposal is aimed at reducing the cost and complexity of determining the classification of debt and improving the transparency and consistency of information provided to users of financial statements about an entity’s debt arrangements.
The debt classification guidance in ASC 470-10-45 provides different rules and exceptions that were developed over time to address the balance sheet classification of a variety of debt arrangements. Some of the guidance requires entities to consider management’s expectations of when the debt might be settled, while other guidance focuses on the terms and conditions of the debt arrangement. The lack of an overarching principle has led to inconsistencies in the application of the guidance.

This project is part of the FASB’s broader simplification initiative. The proposed changes would also increase convergence with IFRS.

**Key considerations**

The proposal would apply to entities that present a classified balance sheet and would apply to all debt arrangements, including convertible debt and mandatorily redeemable financial instruments that are accounted for as liabilities. 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.”

The proposal would require debt arrangements to be classified as noncurrent when either of the following criteria are met as of the balance sheet date:

- The liability is contractually due to be settled more than one year (or operating cycle, if longer) after the balance sheet date.
- 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.

**How we see it**

Although convertible debt is included in the scope of the proposed guidance, it is unclear whether convertible debt that can be converted within one year at the holder’s option would be classified as current. In practice today, convertible debt instruments that holders can currently convert or convert within one year are not classified as current because the settlement (i.e., conversion) does not require the use of current assets and does not affect the entity’s liquidity.

Under the proposal, entities would base their determination of whether to classify debt as current or noncurrent on facts and circumstances existing as of the balance sheet date. With the exception of certain waivers of debt covenant violations, an entity would only consider its contractual rights as of the balance sheet date and not rights received or events occurring after the balance sheet date but before the financial statements are issued.

**Illustration 1: Revolving credit facility with borrowing limit**

Entity A has a revolving credit facility that provides for borrowings up to $4 million but limits the amount to be borrowed to 50% of its trade receivables (borrowing limit). Amounts borrowed under the arrangement have stated maturities of 90 days and can be renewed every 90 days at Entity A’s option over the next three years. Any outstanding balance amounts that exceed the borrowing limit at the renewal date are due within 30 days of that date. As of 31 December 2016, $2 million is outstanding under the revolving credit arrangement.
Borrowing limit not exceeded

At 31 December 2016, Entity A has trade receivables of $6 million. Therefore, the borrowings under the arrangement do not exceed the borrowing limit of $3 million (50% x $6 million). Entity A would classify the entire balance as noncurrent. Although the borrowings have stated maturities of 90 days, Entity A has a contractual right to defer settlement of the liability for at least 12 months as of the balance sheet date by virtue of its option to renew the arrangement over a three-year term.

Borrowing limit exceeded

At 31 December 2016, Entity A has trade receivables of $3 million. Therefore, the borrowings under the arrangement are limited to $1.5 million (50% x $3 million). Entity A would classify the $0.5 million above the borrowing limit as a current liability because that amount is due to be settled within 12 months. The remaining balance of $1.5 million would be classified as noncurrent because Entity A has a contractual right to defer its settlement by continually renewing the arrangement for at least 12 months.

How we see it

Requiring entities to only consider rights that exist as of the balance sheet date would simplify how they determine whether to classify debt as current or noncurrent because the assessment would no longer require judgment.

Short-term debt refinanced on a long-term basis

One of the most significant changes that the FASB is proposing pertains to short-term debt (i.e., debt that is scheduled to mature within one year (or operating cycle, if longer) of the balance sheet date) expected to be refinanced on a long-term basis. Under current US GAAP, short-term debt is classified as noncurrent if the debtor can demonstrate its intent and ability to refinance the debt on a long-term basis before the financial statements are issued.

Under the proposal, entities would no longer be able to consider refinancing after the balance sheet date but before the financial statements are issued when classifying debt as current or noncurrent. Therefore, all short-term debt would be classified as current liabilities regardless of whether the entity intends to refinance it after the balance sheet date.

How we see it

If the proposal is finalized, entities that now rely on long-term refinancing after the balance sheet date but before the financial statements are issued to support the classification of the debt as noncurrent would need to refinance short-term obligations earlier (i.e., before the balance sheet date) to classify them as noncurrent.

Exception for waivers of debt covenant violations

Often, entities that have violated a debt covenant as of a balance sheet date seek a waiver of that violation for a period of more than one year (or operating cycle, if longer) from the balance sheet date. These waivers are typically received after the balance sheet date. The FASB proposed an exception to address this timing issue because, without it, the proposal would have required an entity to classify debt as current if a covenant was violated and a waiver was not received as of the balance sheet date.

Under the exception, an entity would be allowed to consider waivers obtained after the balance sheet date but before the financial statements are issued. An entity would be required to assess whether a violation of a covenant, other than the one that is included in the waiver, is probable within the next 12 months. If such a violation is probable, the entity would be required to classify the debt as current.
The exception would apply to all waivers except those that modify the debt in a manner that results in an extinguishment pursuant to ASC 470-50\(^2\) or a troubled debt restructuring pursuant to ASC 470-60.\(^3\) In addition, an entity would be required to separately present on the face of the balance sheet debt that is classified as noncurrent as a result of this exception.

**Illustration 2: Covenant violation and waiver**

Entity B has outstanding debt bearing a 6% interest rate that matures in 10 years. The arrangement requires Entity B to maintain a minimum working capital balance of $1.5 million and a maximum debt-to-equity ratio of 4.0 throughout the term. Entity B must meet the covenants on a quarterly basis. On 31 December 2015, Entity B has $1.3 million in working capital due to a sales decline, resulting in a covenant violation that gives the lender the right to call the debt. Entity B issues its 31 December 2015 financial statements in March 2016.

In January 2016, the lender agrees to waive its right to call the debt for 12 months from the balance sheet date due to the working capital covenant violation. In granting the waiver, the lender modifies the debt by removing the minimum working capital balance requirement and increasing the interest rate to 9%.

Because the lender did not grant a concession, Entity B determines that the modification is not a troubled debt restructuring pursuant to ASC 470-60. Additionally, as the increased interest rate does not change the present value of the cash flows by at least 10% compared with the remaining cash flows of the original debt, Entity B concludes that the modification is not an extinguishment pursuant to ASC 470-50. Entity B also determines it is probable that the maximum debt-to-equity ratio will not be exceeded during the next 12 months.

The debt would be classified as noncurrent and presented in a separate line item on the balance sheet, with a caption indicating that the noncurrent classification resulted from the exception.

**Subjective acceleration clauses**

Under the proposal, subjective acceleration clauses (SACs), which allow a lender to accelerate the debt’s maturity under conditions that are not objectively determinable, including when a material adverse change occurs, would only affect classification when triggered. This would treat SACs like debt covenant violations rather than as debt due on demand.

**Disclosures, transition and effective date**

The proposal would require disclosures about triggered SACs and debt covenant violations, including an explanation of the deficiency and information about the defaulted amount, the terms of a waiver and the action an entity has taken or will take to remedy the deficiency.

Entities would apply the guidance prospectively to all debt arrangements that exist as of the date of initial adoption. Early adoption would be permitted. The FASB will determine an effective date after considering stakeholders’ feedback.

**Endnotes:**

1. ASC 470-10-45, Debt – Overall – Other Presentation Matters.
2. ASC 470-50, Debt – Modifications and Extinguishments.
3. ASC 470-60, Debt – Troubled Debt Restructurings by Debtors.