What you need to know

- The FASB revised its proposal on the balance sheet classification of debt to clarify how entities would apply the principle-based approach it proposed in 2017.

- Entities would still be required to classify debt as noncurrent if it is contractually due to be settled more than one year after the balance sheet date or the entity has contractual rights to defer the settlement for more than one year after the balance sheet date, but the proposal would clarify the following matters.

- Entities would not be able to consider their ability to refinance debt using separate arrangements, such as letters or lines of credit, in place on the balance sheet date.

- An entity would classify convertible debt on the basis of when it is contractually due to be settled in cash (or other current assets), rather than on the timing of any conversion to equity shares. However, debt that must be settled entirely in equity shares of the borrower within 12 months after the balance sheet date would be classified as current.

- If a borrower violates a covenant in a long-term debt arrangement but the debt isn’t callable at the balance sheet date because the arrangement provides a contractual grace period, the debt would be classified as noncurrent. The proposal would also clarify that the guidance applies to lease liabilities under ASC 840 and ASC 842.

- Comments are due by 28 October 2019.

The proposal would require entities to focus on legal rights that exist as of the balance sheet date.
Overview

The Financial Accounting Standards Board (FASB or Board) revised its proposal to replace the rules-based guidance on debt classification in Accounting Standards Codification (ASC) 470-10-45 with a principle for determining whether debt should be classified as current or noncurrent on the balance sheet.

Like the 2017 proposal, the revised proposal aims to simplify the guidance by requiring entities to focus on legal rights that exist as of the balance sheet date. It also would provide an exception that would allow entities to consider waivers of debt covenant violations they receive after the balance sheet date but before the financial statements are issued.

The FASB revised the proposal to address feedback it received on the initial exposure draft and in outreach the staff performed. The revised proposal would, among other things, preclude an entity from considering separate unused long-term financing arrangements when classifying debt and allow the consideration of grace periods.

Key considerations

The proposal would require entities that present a classified balance sheet to classify debt arrangements 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 a period greater than one year (or operating cycle, if longer) after the balance sheet date.

Because the classification principle would focus on legal rights that exist as of the balance sheet date, entities would no longer be able to consider their intent and ability to refinance short-term debt after the balance sheet date but before the financial statements are issued.

In the revised proposal, the Board clarified that the principle would focus on legal rights provided in the debt arrangement. Therefore, an entity would not be able to consider its ability to refinance the debt using a separate unused long-term arrangement, such as a letter or line of credit, that is in place at the balance sheet date. As a result, all debt arrangements with contractual maturities in the next 12 months would be classified as current liabilities unless they give the borrower a contractual right to defer settlement (e.g., an option to extend the term of the debt for a period greater than one year from the balance sheet date).

How we see it

Requiring entities to consider rights that exist as of the balance sheet date would simplify the determination of whether to classify debt as current or noncurrent because it would no longer require judgment.

However, entities would have to classify more short-term debt as current because (1) they would no longer be able to consider their intent and ability to refinance the debt after the balance sheet date to support classifying it as noncurrent, and (2) they would not be able to consider other unused long-term financing arrangements.

Under the proposal, not-for-profit business-oriented health care entities that issue variable rate demand bonds with remarketing agreements that are secured by unused letters of credit would have to classify those liabilities as current.
The scope of the proposal

The revised proposal states that the guidance would apply to debt arrangements, including convertible debt, as well as lease liabilities under ASC 840\textsuperscript{2} and ASC 842\textsuperscript{3} and mandatorily redeemable financial instruments that are accounted for as liabilities under ASC 480.\textsuperscript{4}

Instruments requiring settlement in shares

Entities that issue convertible debt would classify that convertible debt based on when the liability is contractually due to be settled (i.e., when there is a required use of current assets), rather than when the debt instrument can be converted into equity shares.

In its redeliberations, the Board considered how an entity would classify a debt arrangement whose contractual terms specify that it will be entirely settled through the issuance of equity shares. In this case, the Board stated that an entity would determine the classification of the debt on the basis of when the liability is contractually due. Consequently, if a debt arrangement is contractually required to be settled entirely in equity shares within 12 months after the balance sheet date, the debt would be classified as current.

How we see it

This aspect of the proposal would change practice by requiring current classification of liabilities that are required to be settled entirely in shares within 12 months after the balance sheet date.

Contractual grace periods

The revised proposal addresses long-term debt arrangements that provide a grace period to cure a covenant violation. A borrower that violates a debt covenant in such an arrangement would continue to classify the debt as a noncurrent liability if it isn’t callable on the balance sheet date, due to the grace period specified in the arrangement.

If a violation of a covenant in a debt arrangement that provides a grace period that expires after the balance sheet date is not 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 call the debt, the entity would be required to disclose an explanation of the violation, the amount of debt subject to the violation and the terms of the grace period. For covenant violations without a contractual grace period, the proposal would require disclosure of an explanation of the default, the amount of debt subject to the violation and the terms of any waiver.

How we see it

This aspect of the proposal is consistent with the principle that entities should focus on the contractual rights and obligations as of the balance sheet date.

Waivers of debt covenant violations

One exception to the principle of focusing on the legal rights that exist as of the balance sheet date would involve waivers of debt covenants, as the FASB initially proposed. Entities that have violated a debt covenant as of a balance sheet date often 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. To address this timing issue, the FASB proposed an exception that would allow entities to consider waivers obtained after the balance sheet date but before the financial statements are issued.
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 or a troubled debt restructuring pursuant to ASC 470-60. When applying this exception, 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. Separate presentation on the face of the balance sheet would be required for the debt classified as noncurrent as a result of this exception.

Transition and effective dates

The revised proposal states that entities would apply the guidance prospectively to all debt arrangements that exist at the date of adoption and all arrangements entered into after that date. The Board will determine the effective dates based on the feedback on the proposed amendments. Early adoption would be permitted.

Endnotes:

1 ASC 470-10-45, Debt – Overall – Other Presentation Matters.
2 ASC 840, Leases.
3 ASC 842, Leases.
4 ASC 480-10, Distinguishing Liabilities from Equity.
5 ASC 470-50, Debt – Modifications and Extinguishments.
6 ASC 470-60, Debt – Troubled Debt Restructurings by Debtors.