Defining Issues®

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FASB Proposes Simplification to Balance Sheet Classification of Debt

As part of its simplification initiative, the FASB proposed changes to how companies classify debt as current or noncurrent on the balance sheet. The proposal would replace the existing detailed guidance with a principles-based approach that considers a company's facts and circumstances as of the balance sheet date.[1]

Key Facts

- The proposed Accounting Standards Update (ASU) would apply to a company that presents a classified balance sheet.
- The proposed requirements would apply to all debt arrangements including convertible debt instruments and liability-classified mandatorily redeemable financial instruments.[2]
- Debt would be classified as noncurrent only when it is due more than one year (or operating cycle, if longer) after the balance sheet date, or when a company has the contractual right at the balance sheet date to defer settlement for more than one year (or operating cycle, if longer) after the balance sheet date.
- As an exception to the principle, a company that obtains a debt covenant waiver after the balance sheet date, but before financial statements are issued (or available to be issued), would still classify the debt as noncurrent unless the waiver results in a debt extinguishment or a troubled debt restructuring.

Key Impacts

- The proposed ASU likely would cause more debt arrangements to be classified as current liabilities than under existing U.S. GAAP.
- Short-term debt that is refinanced on a long-term basis after the balance sheet date, but before financial statements are issued or available to be issued, would be classified as a current liability in contrast with existing U.S. GAAP.
- Financial statement users would need to consider both the balance sheet classification and the related disclosures about post-balance sheet refinancings when evaluating a company's liquidity position.

[1] Proposed Accounting Standards Update, Simplifying the Classification of Debt on a Classified Balance Sheet (Current versus Noncurrent), January 10, 2017, available at www.fasb.org.

[2] A debt arrangement provides a lender a contractual right to receive consideration and a borrower a contractual obligation to pay consideration on demand or on fixed or determinable dates.

Classification of Debt

The proposed ASU would establish a general principle requiring debt to be classified based on facts and circumstances that exist as of the balance sheet date. It would require a company to classify its debt as noncurrent if:

- The liability is contractually due to be settled more than one year (or operating cycle, if longer) after the balance sheet date; **or**
- A company has a contractual right as of the balance sheet date to defer settlement of the liability for at least one year (or operating cycle, if longer) after the balance sheet date.

Exception for Waivers Obtained on Debt That Is Callable Due to a Covenant Violation

The proposed ASU would provide an exception to the general principle for debt classification when a lender has the right to demand payment because a covenant violation exists as of the balance sheet date. A company still would classify this debt as noncurrent if it meets several criteria:

- The debt would have been classified as noncurrent if the covenant violation had not occurred;
- The lender waives its right to demand payment of the debt for a period greater than one year (or operating cycle, if longer) from the balance sheet date;
- The borrower obtains the waiver before it issues its financial statements (or before the financial statements are available to be issued);
- It is not probable that the borrower will violate any other covenants that are not covered by the waiver within the next 12 months (or operating cycle, if longer) from the balance sheet date; **and**
- The waiver does not result in a modification that is accounted for as either an extinguishment of debt or a troubled debt restructuring.[3]

Disclosure Requirements. A company would have to present debt that is classified as noncurrent as a result of the waiver on a separate line item on the face of the classified balance sheet. A company also would have to disclose the terms of the waiver (including period of the waiver).

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[3] A debt restructuring is a troubled debt restructuring if the lender for economic or legal reasons related to the borrower's financial difficulties grants a concession that it would not otherwise consider. See ASC Subtopic 470-60, Debt—Troubled Debt Restructurings by Debtors and ASC Subtopic 470-50, Debt—Modifications and Extinguishments, available at www.fasb.org.

The FASB decided not to provide guidance about when to recognize fees related to the waiver of debt covenants.

KPMG Observations

The FASB decided to permit the exception for borrowers who received waivers of debt covenant violations, based on feedback from stakeholders, including the Private Company Council, that it may be impractical to obtain a waiver of a debt covenant before the balance sheet date.

This exception to the principle produces a result similar to existing U.S. GAAP. However, unlike existing U.S. GAAP, under the proposal the debt would be classified as current if the waiver results in an extinguishment of debt or a troubled debt restructuring. The FASB believes either situation is similar to issuing new debt and, therefore, the debt should be classified as current as of the balance sheet date.

Example 1: Short-term Debt Refinanced on a Long-term Basis

On December 31, 20X1, the borrower had a $10 million note with a maturity date of September 30, 20X2 and was in compliance with the terms of the note.

On January 25, 20X2, before the borrower issued its December 31, 20X1 financial statements, the borrower and lender agreed to modify the terms of the note. The modification extends the maturity date of the note to September 30, 20X3. There are no other provisions in the agreement that would have required the borrower to classify the note as a current liability in its December 31, 20X1 financial statements.

Classification under U.S. GAAP	Classification under Proposed ASU
Noncurrent liability because the borrower refinanced its short-term obligation on a long-term basis after the balance sheet date but before the financial statements were issued.[4]	**Current liability** because the proposal does not permit the borrower to consider the subsequent refinancing when determining the classification of the note. As of December 31, 20X1 the note was contractually due nine months after the balance sheet date, and the borrower did not have a contractual right as of that date to defer settlement for at least one year.

[4] ASC paragraph 470-10-45-14(a), available at www.fasb.org.

Example 2: Subjective Acceleration Clause	
The borrower has a loan that is due in five years. The loan agreement says that a loan is in default if a circumstance exists that would reasonably be expected to have a material adverse effect on the business. As of December 31, 20X1, the lender has not notified the borrower that the borrower is in default. However, based on circumstances that exist at the balance sheet date, the borrower believes that it is probable that the lender will declare the borrower to be in default within one year.	
Classification under U.S. GAAP	**Classification under Proposed ASU**
Current liability because it is probable that the subjective acceleration clause will be invoked.[5]	**Noncurrent liability** because as of December 31, 20X1 the loan was not due within one year after the balance sheet date, and the lender had not demanded payment or asserted that the borrower was not in compliance with the debt terms. ***Required Disclosures.*** A company would provide disclosures about the event of default once the subjective acceleration clause is triggered.

Disclosure

The proposed ASU would require a company to disclose information about events of default. Events of default include violations of loan covenants and triggers of subjective acceleration clauses. If a default occurs a company would disclose:

- An explanation of the reason for the default;
- The amount of the obligation subject to the default;
- The terms of a waiver (including period of the waiver, if applicable); and
- A description of the course of action that the company has taken, or that it proposes to take to remedy the default.

Additionally, a public company would need to continue to provide other disclosures required by SEC rules and regulations (e.g., Regulation S-K).

[5] ASC paragraph 470-10-45-2, available at www.fasb.org.

The comment deadline is May 5.

Implementation Provisions	
Applying the Proposed ASU	Prospectively for annual and interim periods in fiscal years beginning after the effective date
Early Adoption	Permitted
Effective Date	To be determined after considering stakeholder feedback

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

Contributing authors: Paul H. Munter and Danielle Imperiale

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