November 13, 2019

Mr. Shayne Kuhaneck  
Acting Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
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Norwalk, CT 06856-5116


Dear Mr. Kuhaneck:

The Financial Reporting Committee (FRC) and the Small Business Committee (SBC) of the Institute of Management Accountants (IMA, jointly referred to as the Committees) are writing to share their views on the Financial Accounting Standards Board’s (FASB or Board) Exposure Draft of Proposed Accounting Standards Update (Revised), Debt (Topic 470): Simplifying the Classification of Debt in a Classified Balance Sheet (Current versus Noncurrent).

The IMA is a global association representing over 140,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities, and multinational corporations.

The FRC is the financial reporting technical committee of the IMA. The committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world’s largest accounting firms, valuation experts, accounting consultants, academics and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at www.imanet.org (About IMA, Advocacy, Financial Reporting Committee).

The SBC addresses issues that impact small and medium-sized organizations. On behalf of IMA’s members, the SBC engages and suggests solutions to standard-setters and regulatory agencies such as the FASB, Securities and Exchange Commission, International Accounting Standards Board, Small Business Administration, American Bankers Association, Internal Revenue Service, and others. Additional information on the SBC can be found at www.imanet.org (About IMA, Advocacy, Small Business Committee).

The Committees are supportive of the Board’s simplification initiatives, and the Committees are appreciative of the outreach and consideration the Board has completed prior to the issuance of this revised Exposure Draft (ED). However, the Committees believe challenges would arise when applying the principle as noted in the proposed paragraph 470-10-45-22. Accordingly, the Committees believe certain clarifications are desirable, as discussed below. Further, the Committees question whether all aspects of
the proposed principle will result in improvements to the financial reporting and observe that the ED may create certain inconsistencies and unintended consequences. We discuss our specific observations below.

We also believe a revision is required for Example 1, Case C. When describing the 10% test to evaluate whether modification or extinguishment occurred, the Example states that both the original and the new instruments are not prepayable. However, the Example also states that the debt arrangement in question is in violation of a covenant which may require early repayment. In our experience and as discussed in some of the interpretive publications by accounting firms, when performing the 10% test with respect to a debt instrument that contains put and call features, judgment is required to determine whether scenarios involving the exercise of puts or calls should be taken into consideration. In this example, the original instrument is in default and therefore, absent the modification, immediate repayment may be required. The choices available to the entity are likely to repay the instrument in default, or to modify and increase the interest rate, as negotiated with the lender. Given these choices, we believe it would be appropriate that the 10% test in the Example also consider the prepayment (put) scenario for the original instrument.

Finally, we believe the Board should permit entities a sufficient period prior to the effective date for adoption. For public entities, 2 years, and for private entities, 3 years, may be appropriate to have sufficient time to re-negotiate current debt agreements.

**Principle Clarifications**

Many debt instruments have complex terms such as contingent puts and calls, provisions for variable cash flows, and installment-based principal repayments where the amount of the principal that is legally remaining at any reporting date differs from the amount recorded for accounting purposes. These terms are not new to the debt arrangements, and practice has developed to address debt classification. However, the revised ED changes the underlying principle of debt classification, and additionally, intentionally breaks the connection with the definition of current liability in multiple ways (as discussed below), which practitioners use by analogy today when determining the classification of their debt instruments with complex features. While we appreciate that the new underlying principle is simple, we do not believe it provides sufficient tools to deal with all of the complexities of existing debt instruments, changes to existing practices and challenges in application. We believe it will create inconsistencies among entities.

Below are specific examples of debt instruments where we believe application of the standard will likely create application challenges.

- Debt arrangements in which the outstanding principal cannot exceed an amount tied to a balance sheet measure (e.g., borrowing base of accounts receivable). As we understand Example 9 included in the revised ED, the entity would determine classification of debt based on the borrowing base existing at the balance sheet date. No look-forward into how the borrowing base may change over the course of the subsequent 12 months (and potentially trigger additional principal repayments over that period) would be required.

We contrast these arrangements with debt arrangements in which principal payments are based on future revenues. Based on the Board’s comments in paragraph BC38, we understand the Board’s intention is that entities continue with the current practice of classifying debt based on estimated
payments that will be required over the following year. To this effect, the Board commented that ‘estimates’ and ‘expectations’ are not synonymous. However, the Board’s rationale in this scenario appears to be inconsistent with Example 9 and the accompanying rationale. As of the balance sheet date, the entity may only have a limited volume of, or even no, binding purchase orders (or contracts) with customers that will generate revenues over the following year. Entities also often have the right to decline taking additional customer orders. Applying the proposed principle and the rationale in Example 9, an entity should not look forward into how its orders (and committed sales) may evolve over the course of the year. Instead, it should only classify as current those amounts of debt that will become due based on the binding orders from (agreements with) customers existing at the balance sheet reporting date, and then only to the extent the entity would not have a contractual right to defer fulfilment of these orders for at least a year.

It is possible that we may not have correctly interpreted the revised ED and the Board’s intentions regarding these two scenarios. We recommend the Board clarify application of the proposed principle in these scenarios within the language of the final Accounting Standards Update (and not in the Basis for Conclusions).

- Debt arrangements may have other contingencies that could result in principal repayment. These contingencies may or may not be in the control of the company. Also, repayment of the principal pursuant to these contingencies may not represent an event of default, nor constitute a subjective acceleration clause. Similar to the preceding examples, we are confused about the intended interaction between language in paragraph BC38 (considering look-forward estimates but not expectations), Example 9 (no look-forward consideration of either estimates or expectations), and the proposed principle in paragraph 470-10-45-22 (consideration limited to the entity’s contractual rights and obligations). Thus, it is not clear to us whether under the revised ED entities should perform a look-forward into whether future events would occur over the following 12 months that could trigger puts, calls or repayment features.

- Many debt arrangements have a structure whereby the recorded debt amount differs from the contractually owed amount. Zero-coupon debt and other debt issued at a discount (e.g., due to concurrent issuance of warrants for no consideration) are examples. Discounts are accreted over time, and contractual (i.e., legally outstanding) amounts of debt principal differ from the amounts recorded for accounting purposes. Still other instruments may have irregular cash flows, e.g., with principal payments in installments that start sometime after the debt is drawn, and/or change over time. As a result, for many debt instruments, as well as for most leases, payments made over the following 12 months after the balance sheet date will not equal interest incurred in the same period. Entities therefore need to define whether a portion of such payments represents partial paydown of the outstanding principal (resulting in the current classification of this amount). These arrangements exist today, and entities assess and determine the current portion of such debt instruments. We believe there is diversity in practice, with some of the approaches based on analogy to the definition of current liability. It is not clear to us whether the proposed principle, which emphasizes contractually due

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1 Our Committees observe that while these words are certainly not synonymous, this nuance in meaning requires a sophisticated user to appreciate. We recommend the Board avoid reliance on nuances and provide sufficient clarity within the language of the final Accounting Standards Update (and not in the Basis for Conclusions).
liabilities, will address this diversity in practice or how the current portion of the debt instrument should be determined in these circumstances.

The following example illustrates the existing diversity in current practice. At the balance sheet date an entity has a debt instrument with a contractual principal balance of $1,000 and a recorded amount (after discounts) of $700. In the following year, a portion of the principal equal to $10 is owed, along with stated interest payment of $50. Total interest expense over the following year will be $100, resulting in an increase in the recorded debt amount. As we understand current practice, depending on the entity’s accounting policy, the current portion of the debt instrument may be deemed equal to (i) $10 (the contractual principal payment due); (ii) present value of $10 discounted at the effective interest rate; or (iii) $0 (as the outstanding debt amount increases over the following year, no portion of the principal is deemed paid).

We recommend the Board clarify its intent with respect to how entities should determine the current portion of debt instruments. In this regard, we also note that proposed paragraph 470-10-45-22 appears to discuss classification of debt instruments in their entirety. Many debt instruments contain current and noncurrent portions; we recommend inserting in the proposed principle language to this effect (e.g., “…shall classify debt arrangements and other instruments, or portions thereof,…”, “if, and to the extent, either of the following criteria…”, etc.).

- Finally, we also note that, strictly speaking, the proposed principle in paragraph 470-10-45-22 appears to be inconsistent with the Board’s intended classification of the debt due on demand. Under the proposed paragraph 470-10-45-22, debt is classified as non-current if either criterion (a) or (b) is met. In particular, criterion (a) says that if a debt instrument is contractually due to be settled in more than one year, it should be classified as noncurrent. A debt instrument that is contractually due in five years but can be repaid on holder demand at any time is still legally contractually due in five years. The fact that the entity does not have a contractual right to defer payment for at least a year (criterion (b)) is not relevant, because only one of the criteria in the proposed paragraph 470-10-45-22 is required for noncurrent classification. While we do agree with the Board’s intended classification of debt as current in this instance, it is not clear to us how the Board concludes on what “contractually due” means in this particular case. In other words, it appears that in this case, to apply the proposed debt classification principle, one needs to consider the holders’ contractual put right and not the actual stated contractual term of the debt as the “contractually due” date. However, there is no guidance in the revised ED that would lead one to this conclusion. Also, the term “contractually due” appears to imply a legal assessment of the contractual provisions of the debt instrument. However, we anticipate that an attorney’s interpretation of what “contractually due” means may differ in many instances with that of an accountant. In our experience, attorneys in their assessment tend to focus solely on the contractual language, while accountants tend to emphasize what they perceive as substance over form, including consideration of probabilities of various settlement alternatives and “worst-case”, i.e. exercise of holder put scenarios.

In paragraph BC19, the Board states its belief that a debt classification principle based on the terms and conditions of the contract (contractual approach) would be more operable because the evidence is more objective. While evaluation of the contractual terms is inherently more objective than that of management intent, the above examples illustrate that solely following the stated terms and conditions of the contract
brings its own challenges. We recommend the Board revise and/or supplement the stated debt classification principle to provide mechanisms to address the above scenarios, including in particular how entities should address the impact of debt call and put options, and when it is appropriate to use forward-looking estimates for purposes of debt classification.

**Improvements in Financial Reporting**

One of the purposes of classifying debt as current or noncurrent is to provide financial statement users with the information required to determine if the company has sufficient current assets to meet its obligations due in the next 12 months. We believe users utilize the current classifications for both assets and liabilities to make estimates of a company’s liquidity and working capital expectations for the next 12 months. For both current assets and current liabilities, today when determining the proper classification entities take into account contractual terms as well as management assertions. The Board states in BC8 that a classified balance sheet prepared under current GAAP does not sufficiently depict liquidity when an entity has (a) violated a debt covenant and received a subsequent waiver or (b) subsequently refinanced short-term debt on a long-term basis. However, we are not clear that the proposed new principle helps users attain a better liquidity analysis, particularly given how the Board provided an exception for debt covenant violations. As such, we believe the proposed principle may not represent an improvement in financial reporting. The Committees have identified several relatively common examples that we believe challenge the revised ED’s usefulness.

- Many companies in the retail industry have outstanding debt facilities and draw upon the debt facility annually as they purchase inventories and carry higher receivables during the holiday season. Historically, these retailers will repay the debt early in the following calendar year, even if repayment within 12 months is not required. Entities also often can demonstrate the intention to repay the debt currently based on prior history and have cash or other liquid assets to make the payments. Under the revised ED, this debt will be classified as noncurrent. However, for liquidity analysis purposes, such classification may not be helpful, as the entity will likely use current assets to repay the debt. While it is true that the entity in this scenario does have a contractual right to continue carrying the debt for at least a year, and thus could elect to defer payment should its economic conditions warrant it, to conserve cash for other current needs, this only remains true for as long as the debt has not actually been repaid. Once the repayment occurs (which could be prior to the issuance of the audited financial statements), the entity no longer has this contractual flexibility.

- Many private companies obtain and renew financing on an annual basis. Under these arrangements, debt is issued with a due date around the time the audited financial statements are expected to be available, and renewal is typically provided prior to the issuance of the audited financial statements. Renewal is usually implicitly contingent on the entity achieving the expected levels of profitability for the preceding year, as evidenced by the audited financial statements. This lending arrangement structure evolved in response to the current debt classification requirements, which result in noncurrent debt classification if the debt instrument is refinanced prior to the issuance of the financial statements. Under the revised ED, debt instruments under such arrangements will be classified as current. While we understand that this is the intended consequence of the new proposed debt classification principle, we challenge whether this change in classification will help users of the financial statements with their liquidity analysis. After all, at the time the financial statements are
issued, it is known for a fact that the use of current assets to repay the debt will not be required, and the entity’s liquidity will not be affected. Our comment is particularly based on the fact that the Board has agreed to provide a specific scope exception via proposed paragraph 470-10-45-25, targeted at private companies that have debt in default at the balance sheet reporting date, to permit classification of debt as noncurrent if waivers are received subsequent to year-end and prior to issuance of the financial statements. It is not evident to us why another exception for completed refinancing activities, also targeted at private companies, would not be appropriate.

As an unintended consequence of the new proposed debt classification principle, we have already heard about some private companies who intend to renegotiate their annual financing arrangements to biennial. What we heard is being contemplated is a standing two-year financing arrangement, that will be modified every year around the time of issuance of the audited financial statements to be extended by one additional year. Thus, an entity will always have a debt arrangement with maturity date extending at least one year beyond the balance sheet date. However, with this change, banks will carry higher risk, and annual debt modification accounting analyses will be required. Thus, we anticipate this practice will lead to higher overall interest costs, as well as incremental executive time and legal, accounting and auditing costs. Other structuring arrangements could also emerge. For example, entities may find that loan covenant violations are preferable to subjective acceleration clauses because they can be waived following the year-end.

- When a note is due beyond one year, but is callable at the borrower’s option and is intended to be called within one year, classification as noncurrent based on the entity’s ability to defer payment for at least a year is also not helpful to the users of financial statements in their analysis of the entity’s liquidity.

- The repayment contingencies and variable cash flow examples discussed in the preceding section also raise concerns about whether debt classification based solely on contractual cash flows would be most beneficial to the users of the financial statements.

We appreciate the effort to streamline the guidance by introducing a comprehensive new classification principle, but based on the examples above, it is not clear to us that the principle introduced in the ED will result in better financial reporting that would justify the changes to current private company practices. In addition, under the ED, users’ liquidity analyses will need to incorporate a careful review of the disclosures in the footnotes to the financial statements, as the working capital information reported in the balance sheet itself will not in many instances reflect the actual anticipated use of current assets for purposes of settling current liabilities.

**Inconsistencies and Unintended Consequences**

The Board discusses in paragraph BC20 potential inconsistencies between the existing definition of a current liability, and the approach toward classification of debt as current or noncurrent in the revised ED. This discussion is focused on consideration of management expectations about primarily the timing of debt settlement, and why such consideration may not be appropriate in the context of a debt instrument. However, the approach to debt classification in the ED will also create other inconsistencies with the definition of a current liability. Current GAAP defines a current liability as an obligation whose liquidation
is expected to require the use of current assets (emphasis added) or creation of other current liabilities. In other words, under current GAAP, liabilities that are settled through the use of assets classified as noncurrent, issuance of noncurrent liabilities, or equity instruments, would not be classified as current regardless of the timing of such settlement.

The revised ED paragraph BC21 highlights the Board’s belief that share-settled debt should be classified solely based on the timing of settlement. We understand that in reaching this conclusion, the Board leveraged, among other things, its understanding of the existing accounting treatment for equity-settled liability-classified warrants. However, in our experience, though there is diversity in practice, many companies report such warrants as noncurrent, even if they can be exercised at any time or even if they will expire if not exercised within one year from the balance sheet date, because their exercise will not require the use of current assets.

Additionally, under the definition of current liability, the analysis is effectively done for an aggregation of all liabilities in the entity. A liability that is to be settled within one year from the balance sheet reporting date by issuance of a noncurrent liability is classified as noncurrent, regardless of whether the original liability would be considered extinguished or modified. Under the revised ED, the analysis is effectively defined to constitute the specific debt instrument being assessed. Thus, refinancing exiting debt with another instrument after the balance sheet date would not change the debt instrument’s classification to noncurrent.

The Board does not explain in the Basis for Conclusions the rationale as to why additional differences from the existing definition of current liability are appropriate. Considering other challenges highlighted in this letter, we do not believe having multiple differences in classification principles is useful for purposes of evaluating the entity’s liquidity, or practical for preparers to apply. We also recommend that the Board consider whether alignment with the definition of current liability as well as the simplification of debt classification could be more effectively achieved by updating the definition of current liability to clarify the extent to which the use of management expectations, forward-looking estimates, and events occurring between the balance sheet date and the issuance of the financial statements may be appropriate.

The Committees also highlight the challenges we expect entities will experience when applying criteria (c) and (d) in proposed paragraph 470-10-45-25, in circumstances where a covenant violation exists. Criterion (c) requires that the waiver must not result in a modification that is either a troubled debt restructuring, or an extinguishment. We had noted in our comment letter to the original ED issued in 2017 that troubled debt restructuring does not, under current accounting standards result in an extinguishment, nor is the modified debt recognized at fair value, which would effectively result in a new debt instrument. Accounting for the debt as current if it is deemed extinguished after the year-end is consistent with the overall approach that only contractual terms existing at year-end are considered for classification purposes. However, reaching a final accounting and auditing conclusion on a subsequent year’s transaction in time to issue the financial statements for a previous year will impose a significant burden on both preparers, especially private entities that will primarily benefit from the application of paragraph 470-10-45-25, and their auditors. Assessing whether a debt modification is a troubled debt restructuring or is substantive (i.e., an extinguishment) may often require extensive analysis, with lengthy technical memos to support these conclusions. Entities will incur additional costs preparing, and incremental audit fees for auditing, their financial statements.
Criterion (d) requires companies to forecast the probability that they may violate other covenants in the next 12 months if one covenant has been violated and a waiver has been received prior to the issuance of their financial statements. Private companies typically do not have robust forecasting processes; requiring these entities to forecast their operations and potential activities outside of their control can impose an undue burden, especially considering that an assessment of each of the existing debt covenants is required. We believe this paragraph should not be included in the final standard as the cost to implement this requirement for private companies will likely not justify the perceived benefits. We also question how this paragraph reconciles with the principle that requires companies to utilize contractual terms and not expectations for purposes of debt classification. Forecasting potential covenant violations is based on both management estimation and expectations and not solely on contractual terms at the balance sheet date.

In summary, we believe the analysis of the waivers in proposed paragraph 470-10-45-25 should be limited to criteria (a) and (b).

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We would be pleased to discuss our comments with the FASB or its staff at your convenience.

Sincerely,

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