November 12, 2019

Technical Director, Financial Accounting Standards Board

File Reference No. 2019-780

Re: Proposed Accounting Standards Update (Revised)

Debt (Topic 470) *Simplifying the Classification of Debt in a Classified Balance Sheet (Current versus Noncurrent)*

The California Society of CPA’s (“CalCPA”) Accounting Principles and Assurance Services Committee (the “Committee”) is the senior technical committee of CalCPA. CalCPA has approximately 43,500 members. The Committee consists of 51 members, of whom 45 percent are from local or regional firms, 32 percent are from large multi-office CPA firms, 12 percent are sole practitioners in public practice, 6 percent are in academia and 5 percent are in international firms. Members of the Committee are with CPA firms serving a large number of public and nonpublic business entities, as well as many non-business entities such as not-for-profits, pension plans and governmental organizations.

Summary of the Committee’s Views on the Proposed ASU

The Committee appreciates the FASB’s efforts to simplify GAAP and increase transparency in financial reporting. However, the Committee disagrees with several of the main proposed changes affecting the classification of debt as a current liability. The Committee believes the proposed classification changes are unnecessary and contrary to the long-standing definition of current liabilities and (in our experience) current practice.\(^1\) The Committee is also uncertain as to whether the proposed changes will achieve any meaningful reduction of the complexity in accounting standards.

Specifically, the Committee disagrees with the Board’s proposed interpretation of the “principle” described in paragraph 470-10-45-22 as it applies to:

- The classification of short-term debt that is refinanced on a long-term basis after the balance sheet date; and

---

\(^1\) The definition of current liabilities is focused on how an entity might expect to liquidate an obligation. Liabilities are generally designated as “current liabilities” only if an entity reasonably expects liquidation to require use of current assets or the creation of other current liabilities (ASC paragraph 210-10-20, SFAS No. 6). This definition was “not intended to include a contractual obligation falling due at an early date which is expected to be refunded” (ARB 30).
The consideration of unused long-term financing arrangements when determining the classification of a debt arrangement.

The Committee believes that if the entity has the “contractual right” to defer liquidation of the liability for at least one year and has exercised (or reasonably expects to exercise) that right, then the liability should be classified as long-term. This classification reflects both the ability and intent of the issuing entity and, in the Committee’s view, contributes to greater transparency in financial reporting. Presentation of the entity’s liquidity and working capital position based on facts at the time the financial statements are issued is far more useful than sending the user to read and understand what are often very complex notes to the financial statements.

The Committee believes that the proposed interpretation and application of the ASC 470-10-45-22 “principle” fails to adequately consider an entity’s reasonable expectations, subsequent events and related “contractual rights” to avoid the use of current assets or creation of other current liabilities to liquidate an obligation. Doing so results in a current liability classification of debt that is inconsistent with both current practice and the long-standing definition of current liabilities.

Such a major change to a long-standing provision of GAAP is only appropriate if there are overwhelming reasons to change, such as serious abuses, transactions outside the scope of the standard, or other significant problems with it. The Committee believes that these circumstances do not exist in this instance to support the proposed changes.

The Committee also questions whether the proposed changes will achieve a meaningful reduction of the complexity in accounting standards for most entities. While the Committee supports simplification, simplification should not be sought by adopting unsound accounting, and the Board has often sought sound accounting at the price of additional complexity. While it may be simpler and less costly for some entities, for many entities, including those with less or moderate complex debt structures, the proposed changes are likely not important considerations.

There have been concerns voiced that limitations or restrictions often exist in a debt arrangement that would have precluded an entity from satisfying other debt obligations as they mature. If this is the case, an unused long-term financing arrangement with those limitations or restrictions cannot be used to support long-term classification under 470-10-45-14b., so this is not a basis for rejecting use of unused long-term financing in classifying debt.

---

2 Cash flow is the same regardless of the contract in which the long-term financing exists. What is relevant is the contractual terms of all unused long-term financing arrangements that the entity has the ability and intent to use to support long-term classification of short-term debt.
Similar concerns have been voiced that there is potential for manipulation under the existing classification standards. If the Board is concerned about manipulation, it is better to deal with it with specific provisions in the standard. And the proposed standard will likely spawn new types of “manipulation” so it may be better to deal with known manipulation that currently exists.

A question has been raised about a situation where amounts might be available under a long-term financing arrangement, but an entity may intend or have a financial need to use the proceeds from the financing arrangement for purposes other than repaying other debt. This is an area where better guidance is needed, and this issue exists under current practice and under the Board’s proposed principle. Currently, and under the definition of current liabilities, if an entity expects to liquidate current debt with current assets or creation of current liabilities, the debt should be classified as current; this is without regard to unused long-term financing arrangements; this may not always be honored in practice. The Board’s proposed principle does not do anything to remedy this, and arguably condones it. It might be simpler to follow the Board’s proposed principle, but it can lead to understatement of current liabilities, which points out a defect in the principle as compared to current GAAP.

But there is not a requirement that the entity actually borrow or intend to borrow under the unused long-term financing arrangement for it to classify short-term debt as long-term, as long as the unused long-term financing arrangement is available (See paragraph 470-10-45-13).

Further, it is not necessary to evaluate all unused financing arrangements; an entity may choose to not include certain financing arrangements in the evaluation because it does not expect to or intend to use them as available to refinance short-term debt. This is within the scope of how management expects to liquidate or not liquidate current liabilities.

A number of other specific situations have been raised where the Board seems to believe that the proposed standard would simplify accounting. For example, it may be unclear how an entity under common control would have allocated an available line of credit across its multiple entities that prepare standalone financial statements. This circumstance exists currently. Allocation of an unused line of credit among entities under common control in standalone financial statements of an individual entity should not be an issue; the entity would need to have irrevocable control over its portion of the line of credit to satisfy current requirements; we suggest that this requirement is not easily met, and additional guidance with regard to this circumstances would be helpful.

Another situation raised a long-term financing arrangement entered into by an entity with a creditor that may be financially incapable of honoring the agreement, and whether this appropriately results in a shift in the classification of current maturities of debt to a noncurrent liability. If this is a concern, it is not difficult to explicitly establish “fences” around what unused long-term arrangements can be used to reduce current maturities of debt. We believe the Board is exaggerating this issue. If a creditor that may be financially incapable of honoring
the agreement, the arrangement with that creditor cannot be used to support a long-term classification under paragraph 470-10-45-14b.

Other Considerations

In addition to these general comments, the Committee has set forth its views with respect to the following areas

- **Undefined payment terms:** There are certain debt arrangements where payment terms are not defined in terms of fixed dates, but in terms of other factors such as sales or operating profits; these may be the sole determinant of payment dates until ultimate maturity, or may accelerate what are otherwise fixed due dates. In these cases, it is necessary to estimate the current portion of the debt arrangement. These types of debt arrangements are referred to in paragraph BC38 and Example 9 (paragraph 470-10-55-45). Example 9 implies that there is no need to consider the effect of estimated decreases in the borrowing base after the balance sheet date, whereas paragraph BC38 seems to require that such estimated decreases be considered. We suggest that this apparent contradiction be clarified and that the use of estimates be explained in the body of the standard (paragraph 470-10-45).

- **Clarification of principle:** There is what appears to be an unintended ambiguity in the principle in paragraph 470-10-25-22a. Does the phrase “contractually due to be settled” refer to the termination date of the lending agreement or the earliest date on which the holder can demand payment (excluding a subjective acceleration clause). For example, a borrower has a five-year lending arrangement, at which time all amounts outstanding must be paid. But the lender can demand payment at any time. When is the loan contractually due to be settled? The loan terms say in five years. We believe most accountants would agree that this is obviously a demand loan which should be classified as a current liability, even though a contractual due date sooner than five years has not been established by the lender. The wording in the principle begs for clarification.

- **Other provisions:** Subjective acceleration and material adverse change clauses, and grace periods: We do support the proposed changes to remove the probability assessment in evaluating classification of debt with subjective acceleration clauses or material adverse change clauses and to allow consideration of grace periods in determining classification of debt.
The following responds to the Questions in the proposed ASU.

**Presentation Matters**

**Question 1:** Proposed paragraph 470-10-45-23 would preclude an entity from considering an unused long-term financing arrangement (for example, a letter of credit) in determining the classification of a debt arrangement. Would that proposed requirement simplify the guidance without diminishing the usefulness of the financial statements? Why or why not?

The Committee believes that the proposed changes which would preclude an entity from considering an unused long-term financing arrangement in determining the classification of a debt arrangement as well as to require the classification of short-term debt that is refinanced on a long-term basis after the balance sheet date as a current liability will diminish the usefulness of financial information provided in the financial statements. Users of financial statements have become accustomed to debt that may be current by its terms being reflected as non-current if there has been a waiver of a covenant violation as well as if there is an unused long-term financing arrangement or there has been a long-term refinancing after the balance sheet date but before the financial statements are issued. The information provided, reflecting the most current information on whether debt is current or non-current, is more useful than the arrangements at the balance sheet which are no longer relevant. We see no reason to change this. We do suggest, however, that both situations should be clearly disclosed on the face of the balance sheet.

Further, as stated above, the proposed requirements that will cause debt arrangements currently classified as long-term to be classified as current is inconsistent with the principle stated in paragraph 470-10-45-22 and inconsistent with the definition of current liabilities (obligations whose liquidation is reasonably expected to require the use of existing resources properly classified as current assets, or the creation of other current liabilities). This will inevitably cause confusion in applying the proposed principle.

There is a logical inconsistency between the use of a waiver of non-compliance with a covenant received after the balance sheet date, without which the debt would not be classified as long-term (a position with which we agree), and the inability to use a post-balance sheet refinancing as a basis for classifying the debt as long-term. Both are similar post-balance sheet date events. Further, the same factors in paragraph BC44 that the Board cited in permitting waivers received after the balance sheet date to support the long-term classification also exist for post balance sheet refinancing. This is especially true for smaller entities which may find it impractical to complete a refinancing until after the balance sheet date.

See above for further discussion.
Question 2: The Board considered and rejected both of the following approaches in determining the classification of debt when an entity has unused long-term financing arrangements that require an entity to:

- Combine the debt with all unused long-term financing arrangements
- Evaluate the contractual linkage between debt and other financing arrangements.

In both approaches, the debt classification might change from a current liability to a noncurrent liability. (See paragraphs BC29–BC35 in this proposed Update for further information.) Is there any additional information about the expected costs and benefits, simplification of classification guidance, or operability of applying those approaches that the Board should be aware of?

We agree with the minority position on combining the debt with all unused long-term financing arrangements, but only to the extent that those arrangements can be used to pay the debt. The Committee believes that the Board reached the wrong conclusion, and would invalidate a classification methodology which in most cases is implemented easily. Fences can be drawn around the types of unused long-term arrangements that can be used in considering debt classification; for example, use of credit lines from financially incapable lenders or with covenants with which the borrower would not comply or with limitations on the use of the credit line to repay debt could be proscribed.

Further, it is not necessary to evaluate all unused financing arrangements; an entity may choose to not include certain financing arrangements in the evaluation because it does not expect to or intend to use them as available to refinance short-term debt. This is within the scope of how management expects to liquidate or not liquidate current liabilities.

We do not support evaluating the contractual linkage between debt and other financing arrangements. It is too complex, and combining the debt with all unused long-term financing arrangements is more workable.

See above for further discussion.

Question 3: Proposed paragraph 470-10-45-24 would provide classification guidance in scenarios in which an entity violates a provision of a long-term debt arrangement and the debt arrangement provides a grace period. Is that proposed guidance clear and understandable? Why or why not?

While the proposed guidance in paragraph 470-10-45-24 is clear, understandable and operable, there are several matters concerning waivers of debt covenant that warrant further consideration. For example, the requirement that a borrower with a current covenant violation must conclude that it is not probable that any other covenant will be violated over that same year (470-10-45-25(d)) raises the following two questions:
• If the borrower concludes that it is probable that other covenants will be violated within a year from the balance sheet date but obtains a waiver of violation of those covenants, should the borrower be able to classify the debt as non-current?

The Committee suggests clarifying that non-current classification of such debt would be appropriate, assuming all other conditions of 470-10-45-23 are met.

• Should accounting consideration be given by borrowers that are not in violation of a particular covenant but believe it probable that they will be in violation of a covenant within 12 months (or operating cycle, if longer) from the balance sheet date?

Under the proposed ASU borrowers who do not have no covenant violations at year-end are held to a different standard for probable violations of covenants within 12 months (or operating cycle, if longer) after the balance sheet date. Specifically, the proposed ASU provides that if the violation of a covenant had not occurred at year-end, the likelihood of violation of another covenant during the ensuing year has no effect on the debt classification at year-end; it would be considered to be a subsequent event when (and if) it occurred. The requirement that the borrower with a waived default must conclude that it is not probable that any other covenant will be violated over that same year for the debt to be non-current is inconsistent with this. We are aware of the Board’s rationale in paragraph BC47. While we see some merit to it, it places the Board in a position of making a probability assessment that the affected entity has a higher risk of other covenant violations without knowledge of the entity or consideration of the nature of the covenant violation. To fix this inconsistency, this requirement would need to be eliminated. Alternatively, all borrowers could be obligated to assess likelihood of compliance with debt covenants over the ensuing year, and if they conclude that it is probable that a covenant will be violated, they would classify the debt as a current liability unless they obtained a waiver. This would be consistent with the expectation embodied in the definition of current liabilities.

The Committee also notes that the example at paragraph 470-10-55-3E may cause some confusion. It states in the eighth line that the original instrument and the new instrument are not prepayable. This fact is not in the base case and its relevance to the conclusion in the example is unclear. Further, the borrower may be able to cause the original instrument to become prepayable by creating an event of default. We suggest that the example be modified or clarified.

**Question 4: Proposed paragraph 470-10-45-22 includes a principle for classifying debt as a noncurrent liability in a classified balance sheet. Would the guidance in that proposed**
paragraph be operable for an entity that has a debt arrangement with contractual terms that require settlement entirely through the issuance of equity?

The provision would not be operable in this situation, and requiring current classification would be inconsistent with the definition of a current liability because liquidation is not reasonably expected to require the use of existing resources properly classified as current assets, or the creation of other current liabilities.

The Committee suggests that the Board's simplification objective might be better achieved by not trying to create a new "principle" which may well be problematic to apply but by using the current definition of current liabilities and the explanations at section 470-10-45, and modify those explanations to deal with the practice issues that the Board perceives. The current literature is reasonably comprehensive and is well understood. Continuing to use it as the basis for a standard would avoid the complications of learning a new standard, avoid the potentially difficult transition to new balance classification, and would achieve simplification by avoiding a major change in the accounting requirements.

See above for further discussion.

Disclosure

* * * * *

Question 5: Proposed paragraph 470-10-50-9 would require that an entity disclose additional information in the period in which the entity violates a provision of a long-term debt arrangement about the violation and the terms of the grace period. Would the proposed requirements provide decision-useful information? Why or why not?

We agree with proposed disclosure.

Expected Costs and Benefits

* * * *

Question 6: The objective of this project is to reduce the cost and complexity for preparers and auditors when determining whether debt should be classified as current or noncurrent in the balance sheet while providing financial statement users with more consistent and transparent information. Given the additional changes in this revised proposed Update, will that objective be achieved? For example, would the expected benefits of the proposed amendments justify the expected costs? Why or why not?

No, it would not. Changes in use of unused long-term financing arrangements in classifying liabilities would necessitate costly modifications to lending and other agreements incorporating, directly or indirectly, the amount of current liabilities in an entity’s financial statements, and would achieve no benefit.
We thank you for the opportunity to comment on these matters. We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Sincerely,

Nancy A. Rix, Chair
Accounting Principles and Assurance Services Committee
California Society of Certified Public Accountants