



April 7, 2017

Ms. Susan M. Cospers, Technical Director
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

Re: **File Reference No. 2017-200**, Proposed Accounting Standards Update, *Debt (Topic 470): Simplifying the Classification of Debt in a Classified Balance Sheet (Current versus Noncurrent)*

Dear Ms. Cospers:

The Financial Reporting Committee (FRC or Committee) of the Institute of Management Accountants (IMA) is writing to share its views on the Financial Accounting Standards Board's (FASB) Exposure Draft (ED) of the Proposed Accounting Standards Update, *Debt (Topic 470): Simplifying the Classification of Debt in a Classified Balance Sheet (Current versus Noncurrent)*.

The IMA is a global association representing over 80,000 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 Committee is supportive of the Board's simplification initiatives and applauds the Board's effort to simplify the balance sheet classification of debt. We believe that balance sheet classification of debt arrangements in accordance with the debt terms at the balance sheet date is easier to apply. For the reasons stated in the basis for conclusions, we accept the proposed exception to the general principle for waivers of debt violations that are received after the balance sheet date but before the financial statements are issued (or available to be issued) provided certain conditions are met. However, we believe certain aspects of the ED should be amended and/or clarified, specifically, the exception described in paragraph 470-10-45-23, the definition of a debt arrangement and application of classification criteria in certain circumstances. The comments below highlight our concerns.

Exceptions

Proposed paragraph 470-10-45-22 states in part that a liability should be classified as noncurrent if, at the balance sheet date, the entity has the contractual right to defer **settlement of the liability** for at least one year after the balance sheet date (emphasis added). Classification questions arise if the liability is contractually due within one year (or for other reasons would otherwise be considered current) but the entity has a commitment, at the balance sheet date, for replacement financing but with a different lender. In such a case, when the commitment is exercised and funds the redemption of the existing debt, current



standards require the existing debt to be considered extinguished (i.e., derecognized), and the new debt to be recognized. If in the ED the Board intends that settlement be synonymous with extinguishment, then despite the refinancing commitment with a counterparty different from an existing lender, we believe the liability at the balance sheet date should be considered current under the Board's proposed model. In paragraph 470-10-45-22, we believe the Board should clarify what is meant by settlement.

In this regard, we believe the Board should clarify Example 2. If the letter of credit issuer in that example is acting as an agent of the issuer, we do not agree that the debt would be classified as noncurrent because settlement has occurred. If the issuer of the letter of credit is acting as an agent, the issuer would have an extinguishment, even if it were not required to repay the issuer of the letter of credit for a period of at least one year (or operating cycle, if longer). If, however, the letter of credit issuer is not acting as the issuer's agent and the transaction is a transfer of debt between the debt holders and the issuer of the letter of credit such that it would have no impact on the issuer's accounting (including its classification of the debt) as discussed in paragraphs 4 and 5 of ASC 470-50-55, then we would agree with the classification of the debt as noncurrent. Given the conclusion in the paragraph 470-10-55-9, we recommend that the Board incorporate in the facts of Example 2 that the issuer of the letter of credit is not acting as an agent of the issuer (with reference to ASC 470-50-55-5).

We acknowledge the practical challenges private companies have when obtaining waivers, as discussed in BC24 and BC25, which led the Board to propose the exception in paragraph 470-10-45-23. However, we believe that the additional criteria in (c) and (d) required in applying the exception result in inconsistencies beyond those already contemplated and also create practical challenges. Specifically, the waiver exception can only be applied if the waiver did not result in debt extinguishment or troubled debt restructuring. On a practical basis, this requires the entity to perform, in the limited time between when the waiver has been received and when the financial statements are issued, what can be a complex technical assessment of whether the debt modification is a troubled debt restructuring or, results in an extinguishment. Such assessment often requires entities to write a complex technical accounting memorandum that could require multiple levels of review within the audit engagement team, potentially involving subject matter experts. It also requires the entity to complete the accounting for a transaction of a subsequent period during the closing process for a previous period, which is different from standard accounting practices for most companies. With the limited time both entities and auditors have after the year-end, this approach can place a significant strain on an entity's ability to issue their financial statements on time.

Further, the Board's inclusion of an exception to noncurrent classification when the waiver includes a modification that qualifies as an extinguishment raises a question as to how a reporting entity should classify debt when, subsequent to the end of the reporting period, the terms of the debt are modified and that modification qualifies as an extinguishment. Should the reporting entity classify that obligation as current at the end of the reporting period, even though it was not in default on the debt at that point? If not, it appears to us as though the Board is being inconsistent with its use of events subsequent to the balance sheet date to conclude on the appropriate classification of debt.

We also do not find the Board's rationale for requiring entities to assess the probability of violating other covenants in BC25 if one covenant has been violated to be convincing or consistent with the proposed debt classification principles.



We recommend limiting the criteria included in paragraph 470-10-45-23 to just (a) and (b). If the Board decides to retain condition (c), we recommend deleting the reference to “troubled debt restructuring” from that condition. While a modification that qualifies as an extinguishment under Subtopic 470-50 requires the issuer to recognize an extinguishment of the existing debt and record the modified debt at fair value, effectively resulting in the issuance of a new debt instrument, a troubled debt restructuring clearly does not have a similar accounting consequence.

Clarifying the Definition of Debt Arrangements

We believe that the definition of debt arrangement needs to be clarified. The definition is broad and we believe could include accounts payable and other accruals in the normal course of business. We do not believe that that is the Board’s intention based on BC15. One approach to clarify the definition might be to indicate that debt arrangements are limited to those that result from financing activities of the entity (based on how those are described in Topic 230).

Applying Classification Criteria

The proposed debt classification is focused on the timing of debt arrangement settlements and not the form of consideration. However, we believe that the final guidance needs to reconcile with Topic 210. As noted in BC15, the Master Glossary states that the classification “current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities.” Further, paragraph 210-10-45-12 states that “the current liability classification is not intended to include debts to be liquidated by funds that have been accumulated in accounts of a type not properly classified as current assets, or long-term obligations incurred to provide increased amounts of working capital for long period”. We suggest that the debt classification criteria in paragraph 470-10-45-22 be expanded to permit debt classification as noncurrent if consideration does not require payment using current assets, or creation of other current liabilities (such as settlement by the transfer of fixed or intangible assets or by the issuance of shares classified as equity).

We believe it would also be helpful to clarify when the debt would be deemed to be “on demand” and classified as current in accordance with the criteria in paragraph 470-10-45-22, and when it may be subject only to disclosure requirements in paragraph 470-10-50-6. For example, a certain Company D will be in default of its long-term debt if a product distribution agreement between this Company D and the lender is terminated. Events of default do not require Company D to repay the debt unless the lender demands it. Company D also does not have a covenant to maintain the effectiveness of the distribution agreement, and thus terminating the agreement does not represent a covenant violation. If as of the period end, the distribution agreement had been terminated, but the lender has not demanded repayment of the loan, it is not clear whether the ED would require Company D to classify the debt as current because the debt has become payable on demand under the criteria of 470-10-45-22, or whether debt would only become current if and when called by the lender, and until such time subject to the disclosure requirements under 470-10-50-6.

Additionally, many debt agreements permit entities to cure covenant violations within a certain time period. In these instances, the lender may not have the right to call the debt unless the violation has not been cured. Some covenant violations are easy to cure, and others, very difficult. For example, a debt



agreement may contain a covenant that the company must notify the lender of a change in control at the time the change in control occurs. This covenant can be cured within 60 days of the event occurring without becoming an event of default, i.e., without triggering the lender's ability to call the debt. Note the change in control itself does not trigger repayment of the debt. However, failure to notify the lender of a change in control does, if not cured within 60 days. It is not clear from the ED whether the debt should be classified as current if a change in control has occurred prior to period end and the company has not notified the lender, even though the requisite 60 day grace period has not yet expired and thus the company can cure the default.

There are also debt agreements where acceleration may be triggered automatically by events outside of either the lender's or the borrower's control. For example, oil and gas entities commonly finance exploration and production with revolving credit facilities secured by petroleum reserves that establish a borrowing base. The value of the reserves is determined by the lender based on a formula and is dependent on commodity prices, expected drilling and completion costs, and other assumptions. The borrowing base is subject to redetermination by the lender semiannually (commonly in April and October), and any amount outstanding under the revolver in excess of the re-determined borrowing base must be repaid in the short term. A question arises as to whether the borrower should classify any portion of the outstanding balance as current if; at the end of the reporting period (but prior to a redetermination of the borrowing base by the lender) oil and gas prices have declined significantly, reducing the value of the reserves and, accordingly, the borrowing base. In that instance, should the borrower assume that oil and gas prices will not change between the end of the reporting period and the next date of redetermination and present the balance outstanding at the end of the reporting period in excess of the hypothetical borrowing balance as a current liability? Or should the borrower wait to reclassify the excess as a current liability until after the lender has redetermined the borrowing base subsequent to the end of the reporting period?

As another example, it has become somewhat common for companies in the life sciences industry to finance their operations through future revenues. For example, an entity may raise \$50 million and be obligated to repay quarterly an amount equal to 10% of that quarter's sales until an aggregate of \$75 million (including interest) has been paid. Usually, this arrangement occurs when the entity starts commercializing its first product, and thus sales volumes are highly volatile and unpredictable but expected to grow rapidly. In this example, the amount of debt principal (\$50 million) repaid over the following 12 months could vary from \$0 to the entire \$50 million depending on the volume of future sales.

It is not clear to us how to apply the ED classification criteria to these types of arrangements because the criteria are solely based on contractual terms. One might argue the entire amount of the revolver/debt should be classified as current because the liability is not contractually due to be settled beyond one year and the entity cannot defer settlement for at least one year. Alternatively, one might argue that the entire amount should be classified as noncurrent because repayment is based either on future notification by the lender, including selection of various assumptions as of a future redetermination date in one example, or in the other example based on uncertain future revenues. Thus, one might argue that the repayment amount is akin to subjective acceleration by the lender which should not be considered until and unless it occurs. We believe either approach is flawed and that the classification criteria should be supplemented to allow the likely repayment amount for the following twelve month period to be



classified as current in these cases. We suggest that Board evaluate these and other situations and provide guidance in expanded examples.

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

Sincerely,

A handwritten signature in blue ink that reads "N. Schroeder". The signature is written in a cursive, flowing style.

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Institute of Management Accountants
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