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Comment Letter No. 27

Ms. Susan M. Cospers
Technical Director
File Reference No. 2017-200
Financial Accounting Standards Board
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Proposed Accounting Standards Update: Debt (Topic 470) – Simplifying the Classification of Debt in a Classified Balance Sheet (Current versus Noncurrent)

Dear Ms. Cospers:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update (Proposed Update) issued by the Financial Accounting Standards Board (FASB or Board).

We support the FASB's simplification initiative and applaud the Board's efforts to reduce the cost and complexity of determining whether debt should be classified as current or noncurrent on the balance sheet and to improve the transparency and consistency of information provided to users of financial statements about an entity's debt arrangements.

We believe that classifying debt based on the legal terms and facts and circumstances that exist at the balance sheet date would be simpler than applying today's rules-based guidance. While questions could arise about the usefulness of the information provided under the proposal because management's expectations would no longer be considered, we believe that classifying debt based on the legal terms and facts and circumstances that exist at the balance sheet date rather than on the borrower's expectations would promote comparability of financial statements.

Waivers of debt covenant violations

We agree with the Board's proposed exception that would require an entity to classify a debt arrangement as a noncurrent liability if it violates a debt covenant but receives a waiver of that violation that meets certain conditions before the financial statements are issued (or are available to be issued). Entities that use this exception would be required to assess the probability of future covenant violations within 12 months after the balance sheet date. However, the requirement to assess the probability of future covenant violations would not apply when the lender waives the covenant requirement before the balance sheet date, but retains future covenant requirements within the next 12 months. We do not believe the timing of when a waiver is received should affect whether an entity has to assess the probability of future covenant violations.

Convertible debt

While we support the proposal, we are concerned that the language proposed as Accounting Standards Codification (ASC) 470-10-45-22(b) could create unintended consequences and diversity in practice because the term “settlement of the liability” is not sufficiently defined. In particular, we are concerned that the proposed language could be interpreted to mean that debt that can be converted into a borrower’s shares within one year at the holder’s option would need to be classified as current even if that debt doesn’t require the use of an entity’s current assets, such as cash, to settle it.

Under today’s guidance, this type of debt isn’t classified as current because settlement (i.e., conversion) of the liability does not require the use of current assets and does not affect the entity’s liquidity. We believe that any new guidance should require that classification depend on whether current assets are needed to settle a liability because the purpose of classifying assets and liabilities as current or noncurrent is to provide financial statement users with information about an entity’s liquidity.

Short-term debt expected to be refinanced

The proposal would eliminate the current guidance on short-term debt expected to be refinanced on a long-term basis and preclude entities from considering refinancings that occur after the balance sheet date but before the financial statements are issued when classifying debt as current or noncurrent. However, we are concerned that the proposed amendments do not clearly explain how a contractual right to refinance as of the balance sheet date affects classification.

We note that proposed Example 2, which would be codified in ASC 470-10-55-7 through 55-9, presents a fact pattern where debt that is redeemable by the holder on short notice is secured by a letter of credit arranged with a lender other than the original lender. The analysis states that this debt can be classified as noncurrent if the letter of credit “allows the borrower to defer the payment for a period of at least one year.” It also says that the “fact that the letter of credit provider is with a different party than the original debt holder is not relevant when determining the classification of the debt.”

It is unclear to us how a refinancing with a different lender, which would be accounted for as an extinguishment, would meet the criterion proposed in ASC 470-10-45-22(b). It appears that in this example, the Board does not consider such an extinguishment to be a “settlement of the liability.” Rather, it appears the Board considers the right to refinance with a different lender a “contractual right to defer settlement of the liability.” We find this example to be inconsistent with the proposed guidance in ASC 470-10-45-23 with respect to a lender’s waiver of its right to demand payment after a covenant violation. That guidance requires noncurrent classification of the debt if certain conditions are met. One of those conditions is that the waiver does not result in a modification of the debt arrangement that is an extinguishment. That is, a waiver that results in a modification that would be accounted for as an extinguishment would cause a debt arrangement to be classified as current. It would appear that under the proposal, debt that is refinanced in a transaction that would be accounted for as an extinguishment of existing debt, and a recognition of new debt, as in proposed Example 2, would be classified differently from debt extinguished in a modification in connection with a covenant waiver, even though the debt in both cases would be extinguished without the use of current assets.



Because entities often borrow under short-term arrangements backed by long-term, standby credit agreements (similar to the fact pattern in proposed Example 2), we believe it is important for the Board to clarify how the borrower should assess a right to refinance under the principle in proposed paragraph ASC 470-10-45-22(b) when such a right exists at the balance sheet date. As we said earlier, we generally believe that classification should be based on whether an entity's current assets are used to settle a liability. We suggest that the Board consider whether the principle in proposed ASC 470-10-45-22(b) should be based on the use of current assets instead of settlement of the liability because the term "settlement of the liability" could include an extinguishment or a settlement of debt that does not require the use of an entity's current assets and, therefore, does not affect liquidity.

Other

We believe the Board should also consider clarifying other aspects of the proposed guidance so it can be consistently applied in practice. For example, while the Proposed Update includes in its scope liabilities recognized from sales of future revenue that are classified as debt, it doesn't provide guidance on whether the borrower should classify any portion of the carrying amount of the liability as current and, if so, how the borrower should measure the current portion of that liability.

We discuss these and other concerns in the appendices to this letter. Appendix A includes our responses to the questions in the Proposed Update. In Appendix B, we provide additional comments on debt with variable principal payments, debt measured at fair value and the language in the proposal.

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

Very truly yours,

Ernst & Young LLP

Appendix A – Responses to questions raised in the Proposed Update

Question 1: Paragraph 470-10-45-22 includes a principle for classifying debt as a noncurrent liability in a classified balance sheet. Would the proposed principle simplify the classification guidance in GAAP without diminishing the usefulness of the information provided in the financial statements? Is the proposed principle clear? Why or why not? Please explain and suggest alternatives.

We believe applying the proposed principles-based approach that focuses on the legal terms and facts and circumstances existing at the balance sheet date would simplify debt classification and achieve the Board's objectives of reducing cost and complexity and providing consistent and transparent information to financial statement users. We do not believe that the usefulness of the financial statement information would be diminished. In fact, the proposal would promote comparability of financial statements by no longer requiring management's expectations to be considered in determining the classification of debt as current or noncurrent. We believe that the balance sheet classification of debt based on the legal terms and facts and circumstances that exist at the balance sheet date would provide useful information to financial statement users.

Debt classification is only one component of the information users need to assess an entity's liquidity. Other information disclosed in the financial statements, such as the scheduled maturities of an entity's long-term borrowings and its subsequent event disclosures, also help users to understand an entity's liquidity position. Further, as part of its project on the Disclosure Framework, the FASB may enhance the information provided in the notes to the financial statements in ways that help users assess an entity's future expected cash flows.

However, we do not believe the proposed criterion that would be codified in ASC 470-10-45-22(b) is clear. Because the term "settlement of the liability" is not defined in the Proposed Update, we are concerned that its application could result in diversity in practice.

Our concerns are twofold. First, we are concerned that using the term "settlement of the liability" could result in the classification of debt as current even if an outflow of an entity's current assets isn't required to settle the debt. Debt arrangements that could be affected include convertible debt instruments that must be settled by converting the debt into the borrower's own shares when a debt holder exercises the conversion option. If conversion is viewed as a "settlement of the liability," a convertible debt instrument that is convertible or becomes convertible at the holder's option within one year would be classified as current under the Proposed Update. If this wasn't the Board's intent, we believe the Board should state in any final guidance that classification of debt as current or noncurrent depends on whether current assets are needed to settle a liability rather than on any settlement of the liability.

Second, it is not clear to us whether the term "settlement of the liability" should be interpreted to include an extinguishment of debt resulting from a refinancing transaction pursuant to ASC 470-50. In this case, the debt extinguishment also does not require an outflow of the borrower's current assets.

Based on the waiver exception in proposed ASC 470-10-45-23 (discussed in Question 3), it appears that an extinguishment of debt in a debt modification related to, or in connection with, a waiver of a covenant violation (e.g., the addition of a substantive conversion feature that would result in extinguishment accounting under ASC 470-50) would cause the debt to be classified as current. However, we find this view to be inconsistent with the Board's conclusion in proposed Example 2 (paragraphs ASC 470-10-55-7 through 55-9) that short-term debt that can be refinanced with a different lender pursuant to an existing letter of credit arrangement would be classified as noncurrent as long as the refinancing arrangement is long term. That is, debt that is refinanced in a transaction that would be accounted for as an extinguishment of existing debt, and a recognition of new debt, as in proposed Example 2, would be classified differently from debt extinguished in a modification in connection with a covenant waiver, even though the debt in both cases would be extinguished without the use of current assets.

We suggest that the Board make its view clear, and we recommend that the Board consider requiring classification to be based on whether current assets are needed to settle the liability. That would be consistent with the purpose of classifying assets and liabilities as current or noncurrent, which is to provide financial statement users information about an entity's liquidity.

Question 2: The scope of the amendments in this proposed Update includes debt arrangements as well as (a) liability-classified mandatorily redeemable financial instruments within the scope of Topic 480, *Distinguishing Liabilities from Equity*, and (b) debt with conversion and other options that are within the scope of Subtopic 470-20, *Debt—Debt with Conversion and Other Options*. Is the scope of the proposed amendments clear? Why or why not? Are there any other instruments that should be included within the scope of the proposed amendments? If so, please explain.

We generally believe the scope is clear. However, given the proposed definition of "debt arrangement," we believe the scope of the Proposed Update may be interpreted more broadly than the Board intended. For example, the proposed definition may include financings that result from payment terms on goods and services related to the borrower's operating cycle (e.g., vendor payables). If this is not the Board's intention, we suggest that the Board clarify any final guidance to make its intention clear.

Question 3: Paragraph 470-10-45-23 includes an exception to the classification principle for waivers of debt covenant violations received after the reporting date but before the financial statements are issued (or are available to be issued). Will including this exception reduce the cost of the proposed amendments? Why or why not? Please explain and suggest alternatives.

We agree with the Board's proposed exception to the classification principle for waivers of debt covenant violations received after the reporting date but before the financial statements are issued (or available to be issued). We believe this exception provides a practical approach to classifying debt with a covenant violation as of the balance sheet date because lenders generally don't issue waivers for anticipated covenant violations before they occur.

We generally agree with the proposed conditions for noncurrent classification of debt that is in violation of a covenant as of the balance sheet date if a waiver is received before the financial statements are issued. However, it is unclear to us why the Board proposed excluding waivers that result in a troubled debt restructuring (TDR) pursuant to ASC 470-60 or an extinguishment of debt pursuant to ASC 470-50 from the exception (criterion (c)). We believe the view the Board expressed in the Proposed Update's

Basis for Conclusions paragraph 27 that waivers resulting in a TDR are akin to the issuance of a new debt instrument is inconsistent with its view expressed in the Basis for Conclusions of Statement of Financial Accounting Standards (SFAS) No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (the debtors guidance in SFAS No. 15 was generally codified in ASC 470-60):

76. The Board also concluded that a troubled debt restructuring that does not involve a transfer of resources or obligations is a continuation of an existing debt. It is neither an event that results in a new asset or liability for accounting purposes nor an event that requires a new measurement of an existing asset or liability.

First, it is not clear to us why a TDR would be treated similarly to an extinguishment of debt. Under ASC 470-60, a TDR is not accounted for as an extinguishment of existing debt and a recognition of new debt. Second, as discussed above, we find the Board's view on extinguishment of debt due to waivers to be inconsistent with its conclusion in proposed Example 2.

We suggest the Board clarify its reasons for requiring proposed criterion (c) under paragraph ASC 470-10-45-23.

Debt arrangements containing a grace period

Debt arrangements may contractually provide borrowers with a period to cure a covenant violation, commonly referred to as a "grace period." If a covenant violation occurs, debt arrangements with grace periods do not provide the lender with a right to demand repayment of the liability unless the borrower is unable to cure the covenant violation during the grace period. For example, a debt arrangement may require a borrower to maintain a certain minimum working capital ratio and deliver a quarterly certificate attesting to compliance with this requirement on each reporting date. In the event of a covenant violation, the debt arrangement may stipulate that the borrower is granted a grace period to cure the violation by the next quarterly compliance date.

Today's guidance provides that if it is probable that a violation will be cured within the grace period, thus preventing the obligation from becoming callable, noncurrent classification is appropriate. The guidance proposed for ASC 470-10-45-23 through 45-24 addresses only the classification of debt arrangements if the lender waives its call right triggered by a covenant violation, but retains the future covenant requirements. However, the proposed guidance does not address the classification of debt arrangements with grace periods.

Absent further clarification by the Board, the proposed guidance could create diversity in practice about how to classify a debt arrangement when a contractual grace period has been triggered. Under one view, which we support, a grace period provision would in substance be similar to a lender's waiver of a covenant violation (which is addressed in the exception to the proposed principle) where future periodic covenant requirements are retained. Under this view, the ability of the borrower to cure the default during the grace period would affect the debt classification. Under another view, a debt arrangement with a grace period that has been triggered might be classified as a noncurrent liability because it was contractually due to be settled more than one year after the balance sheet date.

We recommend that the Board provide guidance on how an entity should consider debt arrangements with grace periods under the proposed principle.

Question 4: Paragraph 470-10-45-24 would require separate presentation in a classified balance sheet for debt that is classified as a noncurrent liability because of a waiver of a debt covenant violation received after the reporting date but before the financial statements are issued (or are available to be issued). Does separate presentation of this amount provide decision-useful information for those using the financial statements? Why or why not? Please explain and suggest alternatives.

We believe that separate presentation for debt that is classified as a noncurrent liability because of a waiver of a debt covenant violation received after the reporting date but before the financial statements are issued (or available to be issued) would provide users with decision-useful information.

Question 5: The proposed amendments would require an entity to classify as a current liability a debt arrangement that is short-term debt (at the balance sheet date) but that is subsequently refinanced as long-term debt (after the balance sheet date but before the financial statements are issued). That would result in more current liabilities and less noncurrent liabilities, as compared with current GAAP. Do you agree that these refinancings are nonrecognized subsequent events? If not, please explain why and suggest alternatives.

We agree with the Board's view that refinancings after the balance sheet date but before the financial statements are issued are nonrecognized (Type 2) subsequent events that should not affect the classification of a debt arrangement as of the balance sheet date under the proposed principle. For these refinancing transactions, we believe subsequent event disclosures pursuant to ASC 855, *Subsequent Events*, would provide adequate information to users about the entity's liquidity.

However, as we said in our cover letter, we do not believe that the proposed amendments clearly define when debt subject to a refinancing arrangement entered into before the balance sheet date can be classified as noncurrent. As currently written, the Proposed Update does not explain sufficiently how proposed Example 2 in ASC 470-10-55-7 through 55-9 complies with the proposed principle in ASC 470-10-45-22(b). Questions that may arise include:

- ▶ Must the borrower obtain the letter of credit (with a different lender) that secures the short-term debt at inception of the debt arrangement, as illustrated in proposed Example 2, to obtain noncurrent classification? Could the letter of credit be obtained after the inception of the debt but before the balance sheet date?
- ▶ How is the Board's statement that "the fact that the letter of credit provider is with a different party than the original debt holder is not relevant when determining the classification of the debt" consistent with the proposed principle in ASC 470-10-45-22(b) that the borrower must have a right to defer settlement of the liability?
- ▶ Should the proposed principle in ASC 470-10-45-22(b) apply if the existing debt may be treated as extinguished or settled within 12 months of the balance sheet date if none of the entity's current assets are used in the transaction (e.g., convertible debt)?

We understand that entities often borrow under short-term arrangements backed by long-term, standby credit agreements (similar to the fact pattern in proposed Example 2 in ASC 470-10-55-7 through 55-9). Therefore, it is important for the Board to clarify how the borrower should assess a right to refinance under the principle in proposed paragraph ASC 470-10-45-22(b) when such a right exists at the balance sheet date to determine the debt classification.

We recommend that the Board consider whether the proposed principle in ASC 470-10-45-22(b) should be based on any settlement of the liability or only settlement that requires the use of current assets. That's because an extinguishment of debt for accounting purposes and certain settlements of debt (e.g., conversions) do not require the use of the entity's current assets. We generally believe that classification should depend on when an outflow of current assets is needed to settle a liability. That would be consistent with the purpose of classifying assets and liabilities as current or noncurrent, which is to provide financial statement users information about an entity's liquidity position.

Classification questions also may arise about financing structures that are similar to proposed Example 2 (paragraphs ASC 470-10-55-7 through 55-9), except that the alternative source of financing (i.e., the letter of credit) with a different lender is not specifically linked to the short-term debt (i.e., the letter of credit does not "secure" the debt). For example, a borrower in a short-term debt arrangement may also have a long-term line of credit with a different lender as of the balance sheet date for general financing purposes (i.e., the credit facility does not specifically secure the short-term debt). If the line of credit has sufficient capacity as of the balance sheet date and does not contractually preclude the use of the facility to refinance the short-term debt, could a borrower conclude that the line of credit provides the entity with a contractual right to defer settlement of the liability?

This situation was previously contemplated by the Board in paragraph 27 of its Basis for Conclusions in SFAS No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced*. The Board said that the "financial position of an enterprise that has refinanced under a linked agreement will be indistinguishable from the financial position of an enterprise that has entered into the same transactions under an agreement that is not linked." We suggest the Board add guidance to clarify this point.

Question 6: Paragraph 470-10-50-6 provides new disclosure requirements. Do the proposed disclosure requirements provide decision-useful information? If not, please explain why and suggest alternatives.

We agree with the proposed disclosure requirements in paragraph ASC 470-10-50-6.

However, we note that since the Proposed Update would delete paragraph ASC 470-10-45-11 in its entirety, it would appear that the existing disclosure guidance in paragraph ASC 470-10-50-2 that makes reference to paragraph ASC 470-10-45-11 (b) should also be removed.

Question 7: How much time would be necessary to adopt the proposed amendments? Would the amount of time needed to apply the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities? Do you agree that early adoption should be permitted?

We do not believe the proposed guidance would be difficult to implement. Therefore, a long adoption period should not be necessary. We do not believe that private entities would need additional time to implement. Finally, we believe that early adoption should be permitted.

Appendix B – Additional observations and recommendations

Classification of debt with variable principal payments

It is unclear how the Proposed Update would apply to debt arrangements that have unknown principal cash flows at the balance sheet date. One example would be a transaction involving a sale of future revenue, which typically involves an entity receiving an up-front payment from an investor in exchange for granting the investor the right to receive a specified percentage or amount of the future revenue (or other measurement of income) of a particular product or service of the entity (e.g., royalties from a drug compound the entity intends to develop and license, 12b-1 fees of a mutual fund distributor) for a defined period. As an example, an investor may provide Company A with \$10 million in return for 10% of Company A's annual revenues from Product X during the next five years, payable annually.

If certain conditions are met, ASC 470-10-25-2 requires the up-front payment to be classified as debt. For accounting purposes, the ongoing cash flows to the investor represent repayments of principal and periodic interest, allocated between the two based on an application of the effective interest method. While paragraph ASC 470-10-15-3 of the Proposed Update includes in its scope "proceeds from sales of future revenue that are classified as debt," it is unclear to us how to apply the proposed debt classification principle to this type of transaction. For example, should the variable on which the principal payments are based be viewed as a future condition that would only affect classification when triggered (e.g., when the future revenue occurs), or should an entity estimate the principal cash flows for the next 12 months and classify that portion of the debt as current? In the above example, the amount of principal repaid over the next 12-month period could be zero if Company A has no revenue, or \$10 million if Company A earns \$100 million in revenue.

One view is that a portion of the debt does not meet either of the criteria in proposed paragraph ASC 470-10-45-22 because, while the amount is unknown, a portion of the principal amount of the debt is due over the next 12 months and the entity does not have a contractual right to defer the settlement of this portion of the principal. Therefore, under this view, the entity should classify the principal payment *expected* during the 12-month period after the balance sheet date as current. Another view is that it is uncertain whether there will be revenues in future periods, and therefore, there is no obligation to repay the debt until future revenues are earned and the amount is known. Under this view, the variability in the principal payments should be viewed as a contingency similar to a subjective acceleration clause and would only affect classification when triggered.

As another example, oil and gas entities frequently use reserve-based revolving lines of credit governed by a borrowing base tied to the present value of the company's oil and gas reserves to fund drilling costs and working capital. The borrowing base is typically calculated by multiplying the volume of oil and gas by the price. The credit agreement usually requires the borrowing base to be recalculated twice per year in the spring and in the fall. This is commonly referred to as the "redetermination event." Upon recalculation, if the amount outstanding under the line of credit exceeds the borrowing base, the amount in excess of the borrowing base generally will be due and payable within a short period of time following the borrowing base redetermination date.

The question becomes, at the balance sheet date, whether the borrower should project the outcome of the redetermination events (which will occur within one year after the balance sheet date) based on information available at the balance sheet date to determine whether any portion of the outstanding debt under the revolving facility should be classified as current.

Debt measured at fair value

The Proposed Update does not address the classification of debt measured at fair value (e.g., an entity may elect the fair value option provided in ASC 825). The fair value of the debt recognized on the balance sheet is composed of both principal and interest cash flows from future periods. The question is, should the cash flows expected during the 12-month period after the balance sheet date be presented as current? One approach could be to determine the cash flows due in the next 12 months after the balance sheet date and discount those cash flows using the interest rate implied by the fair value of the debt.

Given the prevalence of these types of transactions, we recommend that the Board consider providing guidance on how entities should assess these arrangements under the proposed debt classification principle in ASC 470-10-45-22.

Editorial comment

We suggest the following changes to proposed paragraph ASC 470-10-55-45:

However, if ~~all or a portion of~~ the outstanding debt as of the balance sheet date exceeds the borrowing base at the balance sheet date, the borrower would classify ~~that portion of the debt~~ the amount in excess of the borrowing base that would be due in less than one year as a current liability. The remainder of the debt would be classified as a noncurrent liability in the borrower's classified balance sheet because it would meet the criteria in paragraph 470-10-45-22.