FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Memo

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Meeting Date(s)	**September 30, 2016 PCC Meeting**

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Project	**Simplifying the Balance Sheet Classification of Debt**
Project Stage	**Initial Deliberations**
Issue(s)	**Project Direction**

Purpose This Memo

1. The purpose of this memo is to provide Private Company Council (PCC) members with an analysis of the various alternatives for a discussion on the potential direction for the FASB's project as a result of the July 2016 PCC feedback. The staff held an education session with PCC members on August 29, 2016 to educate them further on the various alternatives for the potential direction of this project. During that discussion, PCC members made some new suggestions about the potential direction of the project. Accordingly, the staff considered those suggestions and the FASB would like to receive PCC feedback on some additional questions related to the project direction.

2. This memo is structured as follows:

   (a) Background

   (b) Summary of Prior Outreach

   (c) Issue 1: Refinancing of Short-Term Debt on a Long-Term Basis and Project Direction

   (d) Issue 2: Presentation and Disclosure

(e) Issue 3: Accounting for Fees for Post-Balance-Sheet Waivers and Refinances

(f) Appendix A: Tentative Board Decisions to Date during Initial Deliberations.

Background

Status and Objective

3. The Board is in the final stages of completing its deliberations of this project. The staff presented the Board with the preballot draft of the proposed Accounting Standards Update, *Debt (Topic 470): Simplifying the Classification of Debt on a Classified Balance Sheet (Current versus Noncurrent),* in July 2016 and has also completed external review of that draft. In addition to what is discussed in this memorandum, there are some sweep issues for the Board to consider depending on the direction, including external review feedback and comments from Board members, at a future Board meeting.

4. The objective of this project is to provide guidance that will reduce the cost and complexity of determining the current versus noncurrent classification of debt in a classified balance sheet, while improving or maintaining the usefulness of the information reported to users of financial statements. The Board's tentative decisions would replace the existing narrow-scope guidance with an overriding classification principle. That classification principle looks to the terms of the debt agreement and the entity's contractual rights as of the balance sheet date.

Discussions with the PCC

5. The staff has discussed this project with the PCC at five public meetings over the course of the project as follows:

(a) September 2014: The staff provided an update to PCC members on the project (that it was added to the Board's agenda in August 2014) and its direction (that is, replacing classification rules with a classification principle). PCC members did not express any concerns at this time.

(b) February 2015: The staff updated the PCC on the Board's tentative decisions on the classification principle. The PCC expressed significant concerns about the project and encouraged the FASB to conduct further outreach to stakeholders. The PCC expressed the view that while it supports the simplification initiative, it is concerned that private companies could be significantly affected by the proposal, especially in scenarios in which the proposal would require the reclassification of noncurrent debt to the current liabilities section. The PCC cited four concerns:

   (i) Several PCC members stated that the proposal is conceptually sound, but that there are unintended consequences as a result of more debt being classified as current.

   (ii) Most of the PCC members are concerned with the proposal's effect on existing debt covenants (for example, current ratio thresholds) and, in particular, the treatment for covenant defaults and subsequent waivers.

   (iii) Several PCC members also are concerned that secondary users (for example, suppliers, customers, and credit rating agencies) may quickly conclude that a private company has liquidity issues as a result of debt being classified as current. They noted that such users are more focused on the face of the financial statements and rarely read the disclosures to better understand a company's financial situation.

   (iv) Practitioners on the PCC are concerned that this proposal will trigger extended going concern procedures.

   As a result of this feedback, the staff formed a PCC working group and included members of that working group in additional outreach calls with private company users.

(c) May 2015: The staff updated the PCC on the additional outreach results (see the Summary of Prior Outreach section of this memo for details) . The PCC continued to express concerns about the project. PCC members expressed the view that while they support the simplification initiative, they are concerned that presenting debt as current when a debt covenant is violated as of the balance sheet date but subsequently waived before financial statement issuance date would adversely affect private companies. Most PCC members expressed the opinion that such reclassification could lead vendors, who are generally not as sophisticated as lenders in reading financial statements, to make inaccurate conclusions about a company's financial health. Some PCC members added that such reclassification could further disturb the construction industry in which licensure depends upon working capital calculations.

(i) Because of this feedback, the staff performed outreach with vendors. See the "Summary of Prior Outreach" section of this memo for more details. The staff also performed additional research on the construction industry and shared research with the Board that its tentative decisions may adversely affect construction companies' working capital, which, in turn, has an effect on contractor licensing requirements. Therefore, additional stakeholder education about the potential effect to working capital would be helpful in preparing for the transition to the final standard, when it is issued.

(d) July 2015: The PCC recommended that long-term debt with subjective acceleration clauses (SACs) and/or material adverse change clauses (MACs) should not be classified as current, unless the clauses are triggered. The PCC also recommended that debt covenant violations as of the reporting date that are waived before the issuance of financial statements should not automatically trigger current classification of debt. However, the PCC was split on whether short-term debt that is refinanced before financial statement issuance should continue to be classified as noncurrent.

(e) July 2016: A majority of the PCC expressed an interest toward recommending that the FASB retain the current accounting for refinances in classifying debt as current or noncurrent. Some PCC members also asked the staff to further clarify how to apply the probability assessment when assessing potential future violations of debt covenants.

Board Response to Prior PCC Feedback

6. Throughout the course of the project, the staff has had discussions with the Board to consider feedback from the PCC. As a result of the PCC's feedback, the staff conducted additional outreach and research to address specific PCC concerns (described in the next section), and the FASB addressed two specific areas. The most significant area in which the Board adjusted its decision is the classification of debt in which a covenant has been violated as of the end of the reporting period but a waiver is received from the lender before financial statement issuance. The Board's earlier decisions would have required *current* classification of that debt because the debt is in default as of year-end and the receipt of the waiver is an event that occurred in the subsequent reporting period.

7. PCC members raised this issue because it may be impossible for an entity to obtain the waiver before the balance sheet date. Generally, banks will not issue waivers before the reporting date. The staff's understanding from discussions with PCC members and lenders is that, in general practice, the entity provides the bank with a draft financial statement for the year-end period, the bank provides a waiver, and then the entity later issues its financial statements with the debt classified as noncurrent. The Board recognized the practicability issues and decided to grant an exception to the general debt principle for waivers of debt covenant violations. Under the exception, an entity would be required to consider the receipt of a waiver after the balance sheet date but before financial statement issuance when making the determination of whether to classify debt as current or noncurrent.

8. The Board also considered and agreed with the PCC's recommendations about SACs by requiring that SACs would only affect debt classification when triggered.

Differing Views on Refinances

9. At its July 2015 Board meeting, the Board discussed the PCC view (it was a split view at the time) on refinances and rejected any further adjustments to the principle. Therefore, at present, the main open issue relates to the recommendation by the PCC at its July 2016 meeting to retain current GAAP for short-term debt that is refinanced on a long-term basis after the balance sheet date but before financial statement issuance (or for a private company, when financial statements are available to be issued).

Summary of Prior Outreach

10. This section of the memo provides a summary of the most recent financial statement user outreach, most of which was previously shared with PCC members. This summary does not represent the totality of the staff's user outreach because outreach also was performed as part of pre-agenda research.

PCC Working Group

11. Members of the PCC working group participated in the FASB staff's outreach with four groups of lenders, a credit rating agency, a surety, and a preparer group in the construction industry. A summary of that outreach was shared with all PCC members at its May 2015 meeting.

Lenders

12. The four groups of lenders that participated in the outreach were:
    (a) Professional organization serving about 6,500 small community banks
    (b) Professional organization serving lenders that provide small dollar value loans (that is, under $1 million) up to loans in the billions
    (c) Regional bank with loans ranging from $100,000 to $50–75 million
    (d) National bank—— an individual who is specifically focused on distressed commercial assets.

13. The lenders that the staff spoke with thought that the classification principle proposed by the Board would simplify the accounting. They stated that the proposed principle is relatively straightforward and an improvement over the existing accounting. In regards to debt covenant violations and refinances of short-term debt, the feedback received indicated that those evaluations should be based on the information available as of year-end. That is, if a debt covenant is violated at year-end then the debt is callable and should be presented as current and should be supplemented with additional disclosures. The reasoning for this preference is that it would provide a more prominent display of the breach and it would signal to the lender that there are possible issues with the borrower, even if a waiver is

subsequently granted. One lender commented that under today's accounting, noncurrent presentation (sometimes without disclosure) does not provide the transparency that lenders are looking for. The lenders noted that this would provide them with all of the information needed for their analysis and they could make adjustments as they see fit.

14. The lenders provided the staff with input on how SACs and MACs work in practice. Most lenders shared that the language included in the debt agreements is generally boilerplate for most private companies, but that larger private companies may have clauses that are separately negotiated and reviewed by an attorney. The lenders consistently shared that in practice it is difficult to actually enforce a SAC or a MAC in the courts and that it is rare that they are used to call the debt. In their opinion, the existence of a SAC or MAC should have no bearing on the classification. Rather, it is when the SAC or MAC is triggered that the debt should be reclassified as current.

Ratings Agency

15. The staff spoke with a ratings agency that provides both public company and private company credit recommendations. The discussion focused on the process for private company ratings. During the outreach, the staff obtained an understanding of the company's process for determining ratings to evaluate the potential effect of the classification principle. Payment patterns and bankruptcy filings are the primary data used in determining private company ratings. However, financial statements also are used when available.

16. The ratings agency receives financial statements if the private company volunteers the information. Because of the voluntary nature, generally, the ratings agency receives full financial statements from private companies with strong credit. Many of the financial statements received are audited; however, the ratings agency also receives unaudited financials (or financials without footnotes). The ratio of total assets to total liabilities is the most commonly used metric based on data from the financial statements.

17. For some ratings, the current ratio and quick ratio are used in additional to the total assets/liabilities ratio. The ratings are based on a comparison of an individual company's rating with an industry average. The ratings agency does not have a process in place to track the effect of accounting changes on ratios. Because the ratios are compared with industry

averages, an accounting change typically would not have a significant effect on the comparison. That is, if an accounting change affects the calculation of a specific ratio, then the industry average and an individual company ratio would both be expected to change. The ratings agency does have an appeals process if a company disagrees with its rating.

Construction Industry

18. The staff performed outreach with the second largest surety in the United States and a professional organization in the construction industry (which consists of preparers/consultants in that industry). The individuals expressed significantly greater concern with the proposed principle compared with the lenders and the ratings agency. They also both preferred current GAAP because it relates to classification of debt with covenant violations for which a waiver has been obtained after the balance sheet date but before financial statement issuance.

19. The staff learned that in the construction industry, working capital is a key metric for contractor licensing requirements. Requirements vary by jurisdiction (by state, municipality, etc.). Typically, adjustments are not made to working capital by the contract licensors, and values are obtained from the face of the financial statements with little regard to the footnotes. During outreach, the stakeholders asserted that a change to working capital as a result of this project will most likely affect an entity's ability to obtain a license or bid on jobs.

20. The surety that the staff spoke with shared that he reviews both the face of the financial statements as well as the footnotes. However, he noted that not all of his colleagues do so. There three primary metrics used are (a) interest-bearing debt, (b) debt to equity, and (c) working capital to debt. Only the third model (working capital to debt) would be affected by the change in the classification principle. The company has a process to monitor accounting changes. For example, it is currently monitoring the leasing and revenue standards. It plans to make adjustments to analysis and documentation (for example, forms) on the basis of changes to GAAP.

Other Outreach and Research Performed in 2015

21. After the May 2015 PCC meeting, the staff performed additional research and outreach in response to the PCC's concerns. That outreach focused on vendors and academic research on debt covenants.

Vendors

22. At the May 2015 PCC meeting, PCC members were concerned that, under the Board's tentative decisions, the balance sheet would be misleading to financial statement users, particularly vendors and customers who might not read disclosures. Therefore, the staff performed additional outreach with vendors.

23. The vendors that were included in outreach are both large public companies in the consumer products and food and beverage industries. Although the vendors themselves are public companies, <u>they have a large volume of private company customers</u>. In discussions with both of these vendors, the staff obtained an understanding of the credit approval process and feedback on the Board's tentative decisions.

24. The first vendor uses a quantitative assessment—a five-point matrix—as its first step in its credit process. Included in this matrix is one input (current ratio) that would be affected by the Board's proposal. Also, credit ratings agencies are sometimes utilized in instances in which financial statements may not be available. Once the results are calculated by the formula, the vendor will request additional information from the customer on the basis of its judgment. That is, the decision on whether or not to extend credit is not merely based on the quantitative information. The vendor thought that the Board's tentative decisions would overall be beneficial because the change would provide transparency on any potential issues in a timelier fashion compared with the existing guidance. Classification of the debt as short term on the face of the balance sheet would signal to the vendor that it might want to get more information about the liquidity of its customers; whereas under the existing accounting guidance, the red flags are not as evident (because the violation would be included in the footnotes and would not affect the face of the balance sheet).

25. The second vendor's process was less form driven than the first. This vendor does not rely on ratios for screens, but, rather, looks at the overall strength of the balance sheet. For short-

term debt, that vendor generally has discussions with the chief financial officers (CFOs) of other vendors to understand the nature of the loans and the companies' plans. That is, it would not immediately cut off credit because of an increase in short-term debt. Rather, it would prompt a conversation with the company. That vendor noted that it always looks at the debt section of the footnotes. Generally, this vendor receives audited financial statements from private company customers. This vendor viewed the FASB's proposal as a positive change because of an increase in transparency in the financial statements about potential liquidity issues.

26. Although the second vendor provided feedback on its own company practices, this person also is involved with several industry groups and noted that smaller vendors may not perform their credit checks with the same level of detail. That is, smaller vendors may be more reliant on ratio analysis. However, this person noted that the FASB could leverage industry organizations to help educate companies about the change before the standard becomes effective.

Academic Research on Debt Covenants

27. On several occasions—most recently at the July 2016 PCC meeting—some PCC members have raised the potential effect of a change in the classification of debt on an entity's compliance with debt covenants. One potential issue is that a change in classification of debt could cause a company to be in default of debt covenants on the basis of reported financial statement numbers. During outreach, the FASB staff was told by some stakeholders that many covenants are written to exclude the effects of mandated accounting changes, reducing the likelihood that debt covenants would be systematically affected by the guidance in this proposal. However, to corroborate this, the staff reviewed several academic research papers on debt covenant violations and summarized the results in this section of this memo.

28. The research reviewed by the staff indicates that covenant violations caused by mandated accounting changes are not the norm in practice. However, this research was not geared specifically toward either private companies or public companies. The academic research shows that loan agreements commonly base the covenant calculations on the GAAP in effect as of the inception of the loan. One academic study noted that only 24 percent of

companies use GAAP in effect as of the date of the covenant calculation (referred to as rolling GAAP). Debt agreements that use a method of frozen GAAP for covenant calculations have a lower cost of renegotiation (when a covenant is violated) and a lower cost of debt overall. Debt agreements using rolling GAAP generally have higher interest rates. This is because covenants that are affected by mandatory accounting changes have a higher contracting cost because those covenants had been carefully agreed upon on the basis of the existing accounting rules when the agreements were signed. Also, it may be difficult for lenders to determine if violations that occur after accounting changes are indicative of a change in loan quality or are a false warning. However, frozen GAAP methods require some form of dual bookkeeping. For that reason, some entities may choose to calculate debt covenants using rolling GAAP if the higher cost of debt (that is, through additional fees or increased interest rates when waivers are granted) is lower than the cost of dual bookkeeping.

Issue 1: Refinancing of Short-Term Debt on a Long-Term Basis and Project Direction

Refinancing: Current GAAP

29. Current GAAP requires noncurrent classification of short-term debt to be refinanced on a long-term basis if a borrower has both the intent and ability to refinance on a long-term basis. According to paragraph 470-10-45-14, a borrower’s ability to consummate a refinancing can be demonstrated in either of the following ways:

(a) Issuance of a long-term obligation or equity securities after the balance sheet date but before financial statement issuance

(b) Entering into a financing agreement before financial statement issuance that permits the entity to refinance on a long-term basis in which all of the following conditions are met:

(i) The agreement does not expire within one year and is noncancellable by the lender, except for violation of an objectively determinable provision (that is, no SACs).

(ii) No violation of any provision in the agreement exists at the balance sheet date and no information indicates that a violation has occurred before financial statement issuance.

(iii) The lender/investor is expected to be financially capable of honoring the agreement.

30. There is no mention in current GAAP that the consummated refinancing or the financing agreement must be with the same lender as that of the existing short-term debt. Therefore, refinances with third party lenders also qualify for noncurrent classification. If, however, only a portion of the amount of the short-term debt is refinanced or excepted to be refinanced, only that portion can be excluded from current liabilities.

31. Additionally, if equity securities have been issued for the purpose of refinancing the short-term obligation on a long-term basis, the issuance of the equity securities is excluded from owners' equity as of the balance sheet date even though it affects the classification of the debt as of the balance sheet date.

Refinancing: Board’s Tentative Decisions

32. Under the Board’s tentative decisions, short-term debt that is refinanced on a long-term basis after the balance sheet but before financial statement issuance would be classified as a current liability because the refinancing is a Type 2 subsequent event (an event that provides evidence about conditions that did not exist at the date of the balance sheet but arose after that date). Type 2 subsequent events do not affect the classification of debt at the balance sheet date; and, therefore, the Board’s tentative decisions would change current GAAP for these kinds of refinancing arrangements.

33. At the July 2015 Board meeting, the staff presented two alternatives based on the PCC’s feedback on these refinancing arrangements.

(a) Move the classification assessment date to the financial statement issuance date (rather than the balance sheet date). Under this approach, there would be consistency in the assessment in that it would include both negative and positive changes that occur after the reporting date but before financial statement issuance.

For example, the debt classification would be affected by events, such as waivers of debt covenant violations, refinances of debt, prepayments, and violations, that occur after year-end but are not waived as of the financial statement issuance date. The staff could not identify any basis in GAAP for this approach because it would be inconsistent with guidance on subsequent events. In addition, it would be significantly different than International Financial Reporting Standards (IFRS).

(b) Consider whether refinances are with the same lender. Under this approach, if an entity refinances short-term debt on a long-term basis after the reporting date but before financial statement issuance and that refinance is with the same lender, then the entity would consider that refinance in determining the classification of debt. The staff is unable to identify a conceptual or practical reason for this approach. Regardless of whether the refinance is consummated with a new lender or the same lender, the entity is in the same financial position both at and after the balance sheet date. The staff concluded that it may be confusing for financial statement users if the classification is affected solely based upon the lender. The assessment would be simple when an entity is dealing with a single lender, but it becomes complicated when dealing with a syndication of lenders. If the Board were interested in pursuing this approach, the staff expects that implementation guidance would need to be provided on this topic. As evidence of the complexity of this concept, the staff highlights that the IASB had used this concept in its previous attempts to amend IAS 1, *Presentation of Financial Statements*, (in its 2015 Exposure Draft, *Classification of Liabilities*) as it relates to rollovers of debt and received negative feedback from stakeholders through its comment letter process.

34. The Board rejected those alternatives because of the disadvantages described above and decided that the classification principle for refinances should be based on the legal terms that exist at the balance sheet date. Subsequent event disclosures would provide users with information about refinances that occur after year-end, but before financial statement issuance.

Refinancing: Recent PCC Feedback

35. At the July 2016 PCC meeting, a majority of PCC members suggested that the Board retain current GAAP for refinancing transactions, thus requiring noncurrent classification of short-term debt refinanced on a long-term basis after the balance sheet date but before financial statement issuance. The primary basis for their view is that because the entity knows as of the financial statement issuance date that working capital will not be used to settle the debt, it would be misleading to present that debt as current as of the balance sheet date.

36. The staff held an education session with PCC members on August 29, 2016. Eight PCC members attended that session. The purpose of that session was to:

    (a) Educate PCC members on current GAAP on refinances and the probability assessment on waivers of covenant violations

    (b) Discuss the PCC members' views on refinances and other aspects of current GAAP

    (c) Solicit feedback on the path forward.

37. Seven of the eight PCC members in attendance for that session continued to be supportive of retaining current GAAP on refinances of short-term debt on a long-term basis despite the inconsistencies with other post-balance-sheet events. Most PCC members supported the classification of short-term debt refinanced on a long-term basis after the balance sheet date as a noncurrent liability. Those PCC members commented that current GAAP provides information that is more relevant to users than the information that would be provided under the Board's tentative decisions.

38. Because the refinance occurs before the financial statements are issued, PCC members assert that there is no current claim on assets by a lender for the debt in question, and, therefore, the debt should not be presented as a current liability on the borrower's balance sheet. Classifying this type of refinanced debt as a current liability communicates to users that there is a "current call on cash." PCC members concluded that classification would be misleading and raised concerns that it could negatively affect credit decisions. PCC members also continued to disagree with the Board's view that the refinance transaction is

a Type 2 subsequent event. Other PCC members suggested that subsequent events should not affect measurement and recognition, but that classification on the balance sheet should reflect the effects of certain subsequent events. The following is a summary of some issues the staff has identified with retaining current GAAP for refinance transactions, which the staff discussed with the PCC on August 29, 2016.

(a) The PCC was supportive of changing the accounting treatment for SACs to remove the requirement for an entity to assess the likelihood that the due date of the debt will be accelerated by the lender because of the SAC. However, in current GAAP, the existence of a SAC in a refinance arrangement precludes noncurrent classification of the debt.

(b) The PCC also has expressed a view on the effect of the counterparty to the refinance that is different from the requirements of current GAAP. That is, PCC members have generally been supportive of noncurrent classification when the refinance is with the same lender. However, current GAAP allows for noncurrent classification regardless of whether the refinance is with the same lender, a third party lender, or even if the entity issues equity shares to replace the debt.

(c) A PCC member also raised concerns about the application of the refinancing guidance to the replacement of a short-term obligation with equity securities because there is a transaction that clearly occurred after the balance sheet date.

Project Direction: Recent PCC Feedback

39. Some PCC members did express concerns with certain elements of current GAAP, namely that (a) post-balance-sheet prepayments of debt are not explicitly considered and (b) post-balance-sheet issuance of equity securities qualifies as a refinancing transaction even though that is a transaction that occurs in the next reporting period. Some PCC members viewed the issuance of equity securities as a *new* transaction although they do not view a refinance with a new lender in a subsequent period as a *new* transaction. Those PCC members thought that drawing a distinction between debt and equity instruments was important in this case. However, overall, the PCC members who attended the session were generally supportive of retaining current GAAP for refinances despite these issues. In

summary, while PCC members have some specific areas of concern, overall they concluded that current GAAP is not broken.

40. Recognizing that it would be impractical to achieve simplification by continuing to add more exceptions to the classification principle, the staff asked PCC members for input on the project direction. The staff asked whether the PCC members would support:

    (a) Alternative 1: Classification principle based on legal terms, with an exception (and separate presentation) for waivers of debt covenant violations received after the reporting date but before the financial statement issuance date (continue with Board's tentative decisions)

    (b) Alternative 2: Classification principle based on probability (rejected by the Board previously)

    (c) Alternative 3: Retain current GAAP in its entirety; remove the project from the technical agenda.

41. Given the PCC members' views on refinance transactions, PCC members rejected Alternative 1. No PCC members supported Alternative 2. Because the Board previously rejected Alternative 2, the staff has not included any further analysis of that alternative in this memo. PCC members initially gravitated toward Alternative 3 during the discussion. However, on the call, a PCC member suggested a new alternative. That alternative would shift the focus of the project to targeted areas (discussed further in Alternative C below) rather than a wholesale revision to a classification principle. PCC members preferred a targeted approach rather than retaining current GAAP in its entirety and removing the project from the agenda. No PCC members objected to that approach during the discussion.

September 30 PCC Discussion: Project Direction

42. The staff has developed three approaches for proceeding with this project, given the PCC's views:

    (a) Alternative A: Classification principle based on legal terms, with an exception (and separate presentation) for waivers of debt covenant violations received after the reporting date but before the financial statement issuance date (continue with Board's tentative decisions).

(b) Alternative B: Retain current GAAP in its entirety; remove the project from the technical agenda.

(c) Alternative C: Adjust the project objective to focus on targeted areas.

Consideration of the Private Company Decision-Making Framework

43. The staff considered whether the same alternatives would apply to public and private companies. The staff concluded that a private company alternative would be unnecessary based on review of the *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies* (PCDMF). According to the PCDMF, generally, both private and public companies should apply the same financial statement display (the term *display* is synonymous with the term *presentation*) guidance established by the Board. That conclusion was reached in the PCDMF because of the presumption that information that is important enough to be presented on the face of financial statements is relevant to most financial statement users. However, in some circumstances, the Board and the PCC may conclude that private companies should be permitted to apply alternative display requirements. In determining whether to permit a display alternative, the Board and the PCC should assess, among other pertinent considerations, whether the information to be displayed is irrelevant to typical users of private company financial statements, inapplicable to private companies, or whether disclosing the disaggregated or supplemental information about financial statement line items in the accompanying notes would sufficiently address the needs of typical users without fundamentally affecting the comparison of financial statements of private and public companies.

44. Upon review of the PCDMF, the staff concluded that classification of debt as current or noncurrent in a classified balance sheet is relevant to both private company users and public company users. The staff spoke with both private company users and public company users during outreach and did not identify differences in views between the two groups. In past PCC meetings, PCC members also have said that they would not want differences in the

presentation between private companies and public companies for the balance sheet classification of debt. Therefore, the staff does not think that a private company alternative would be appropriate for this issue.

Staff Analysis of Alternatives

Alternative A: Classification principle based on legal terms, with an exception (and separate presentation) for waivers of debt covenant violations received after the reporting date but before the financial statement issuance date (continue with Board's tentative decisions).

45. Under this approach, the Board would affirm its tentative decisions as follows:

    (a) Classification principle—Debt would be classified as a noncurrent liability if either of the following criteria are met as of the balance sheet date:

        (i) The liability is contractually due to be settled more than one year (or operating cycle, if longer) after the balance sheet date.

        (ii) The entity has a contractual right to defer settlement of the liability for at least one year (or operating cycle, if longer) after the balance sheet date.

    (b) A waiver of a debt covenant violation received after the balance sheet date but before financial statement issuance should be considered when determining the balance sheet classification, unless the waiver results in an extinguishment or a troubled debt restructuring in which case a separate presentation of that amount would be required. The probability assessment for covenant violations in current GAAP would be retained, although certain drafting improvements could be made to clarify the probability assessment.

46. It is important to note that although the most recent feedback from PCC members on refinancing transactions was fairly united at the July 2016 PCC meeting, prior feedback on that issue has been more polarized. In prior discussions with the PCC, 50 percent of members supported current classification of the debt when the refinancing occurs after the balance sheet date but before financial statement issuance. When the AICPA Technical Issues Committee (TIC) surveyed community banks in 2003 (during a FASB short-term IFRS convergence project), 56 percent of the community banks surveyed thought that short-term debt refinanced on a long-term basis after the balance sheet date but before financial statement issuance should be classified as current. At the July 2016 AICPA National

Advanced Accounting and Auditing Technical Symposium (NAAATS), some informal polling was done on this topic. By a show of hands, approximately half of the conference attendees were supportive of current classification.

47. Financial statement users (other than PCC members who also are users) generally welcomed the simplification and the focus on the assessment of the contract, noting that it increases transparency in financial reporting. Throughout the two years that this project has been on the Board's agenda, the staff has conducted various rounds of outreach with financial statement users including lenders and private equity, vendor credit, and ratings agencies. The staff believes that an approach focused on the legal terms that exist at the balance sheet date is the most objective approach of the alternatives. Additionally, because this approach is rooted in the contract terms, it is the easiest approach for preparers to apply, accounting firms to audit, and users to understand. This approach eliminates the need for management judgment, except in assessing the probability of future debt covenant violations.

Alternative B: Retain current GAAP in its entirety; remove the project from the technical agenda.

48. As stated earlier, the objective of this project is simplification. The objective of the simplification initiative is to make narrow-scope simplifications and improvements to accounting standards through a series of short-term projects. The projects included in the initiative should improve or maintain the usefulness of the information reported to investors while reducing cost and complexity in financial reporting. Alternative A is the simplest and most operable approach. If the Board were to agree with the PCC to retain current GAAP on refinances, it could be questioned whether the costs of this project would justify the benefits (the staff thinks it is highly unlikely). In that case, current GAAP would be retained for waivers and refinances, and the staff would be rewriting the remaining guidance to get to the same result.

49. The staff expects that this will continue to be a challenging project and is uncertain of the volume or nature of comment letters that the Board would receive during exposure. Additionally, given the breadth of the changes being proposed as well as the length of time this project has been underway (nearly 2.5 years), some stakeholders may not believe this project meets the objective of a short-term simplification project.

50. If the Board still views the objective of this project consistently with its original objective—a simplification project—it may want to remove the project from the agenda. However, if the Board more fundamentally disagrees with the financial reporting results of current GAAP and views improvements in this area as a priority, the Board may want to consider moving forward with Alternative A.

Alternative C: Change the scope of the project to a series of targeted areas.

51. At the August 29, 2016 education session, PCC members noted that their preferred path forward would be to pursue a project that focuses on targeted changes to the classification guidance rather than the development of a classification principle. Most PCC members have expressed a desire to maintain current GAAP for balance sheet classification of debt while also emphasizing the need for certain improvements (some of which are consistent with the Board's decisions on this project).

52. Because this approach had not yet been explored by the Board, this section of the memo will provide the staff's analysis of a targeted project as a potential path forward for the project, as requested by PCC members. The staff has developed a list of possible areas that could be included within the scope of the project if the objective were changed to focus on targeted areas. The staff has organized these targeted areas into the following two groups:

(a) Subsequent events

(b) Assessments of probability.

Subsequent Events

53. Topic 855, Subsequent Events, provides guidance on when transactions that occur after the balance sheet date should be recognized in the financial statements (as opposed to only being disclosed). One potential approach to addressing targeted areas within this project would be to focus on debt-classification-related events that occur after the balance sheet date but before financial statement issuance, possibly including:

(a) Waivers of debt covenant violations received after the balance sheet date but before financial statement issuance (extinguishments and troubled debt restructuring)

(b) Short-term debt refinanced on a long-term basis after the balance sheet date but before financial statement issuance (equity securities)

(c) Prepayments of debt after the balance sheet date but before financial statement issuance

Waivers—Extinguishments and Troubled Debt Restructuring

54. The Board's tentative decisions would require an entity to consider the receipt of a waiver of a debt covenant violation in determining debt classification unless the waiver results in an extinguishment of the debt or a troubled debt restructuring (TDR). The rationale is that if the waiver results in an extinguishment of the debt or a TDR, then a new transaction has clearly occurred in the subsequent period and should not affect the classification of the debt as of the previous reporting period. This approach would better align the debt classification guidance with subsequent events guidance. An outcome of this approach is that it could result in more debt being classified as current because today, entities do not need to consider subsequent extinguishments or TDRs when determining debt classification. Under a targeted approach, this same change to current GAAP could be made.

Refinances of Short Term Debt—Issuance of Equity Securities

55. Under current GAAP, post-balance-sheet issuance of equity securities is considered to be a refinancing and requires noncurrent classification for the debt at the balance sheet date, despite the fact that the equity securities are not recognized in the financial statements until the subsequent period. Board members and PCC members have expressed concerns with current GAAP because the transaction is reflected in the balance sheet presentation in one period, but recognition and measurement occurs in another. Most would agree that the issuance of equity securities in a subsequent period clearly should not be recognized in the financial statements (that is, disclosure only). Changing current GAAP to align the presentation requirements with the subsequent event guidance could result in more debt being classified as current as compared with existing GAAP. However, if this issue were to be addressed in isolation within a targeted approach, there would be tension on whether there should be a difference in classification when debt is refinanced through the issuance of equity securities and when debt is refinanced with a new lender.

Prepayments

56. Current GAAP is silent on whether prepayments made after the balance sheet date should be considered in determining whether debt should be classified as current or noncurrent. Some in practice may consider prepayments within the definition of *current liabilities*, which are those liabilities whose liquidation is *reasonably expected* to require the use of existing resources. However, based on the staff outreach, most in practice do not change the classification of debt on the balance sheet for post-balance-sheet prepayments. Some Board members and PCC members have noted a desire for symmetry in this area, in that prepayments also should be considered when classifying debt if refinances are to be considered (both delays and advances in the use of current capital). It would be difficult to explain why the prepayment of debt after the reporting date but before financial statement issuance would not affect debt classification while the refinancing of debt in that same time frame would. Adjusting the classification of debt for prepayments made after the reporting date would result in more debt being classified as current as compared with existing GAAP.

Assessments of Probability

57. Current GAAP is inconsistent on when contractual terms should prevail versus when management should assess the probability of potential future events in determining the classification of debt. Another potential approach to addressing targeted areas within this project would be to focus on the existing classification guidance that requires probability assessments. Although the PCC has recommended that the Board not pursue its decisions to provide for a classification principle, there could still be some targeted changes to those areas of GAAP requiring probability assessments, possibly including:

(a) SACs

(b) Waivers of debt covenant violations.

SACs

58. Current GAAP requires entities to consider the probability of a SAC being triggered when determining classification of the debt as current or noncurrent. The following is the guidance on SACs:

> **470-10-45-2** In some situations, the circumstances (for example, recurring losses or liquidity problems) would indicate that long-term debt subject to a **subjective acceleration clause** should be classified as a current liability. Other situations would indicate only disclosure of the

> existence of such clauses. Neither reclassification nor disclosure would be required if the likelihood of the acceleration of the due date were remote, such as if the lender historically has not accelerated due dates of loans containing similar clauses and the financial condition of the borrower is strong and its prospects are bright.

59. In this project, the Board decided that SACs would affect the classification of debt when triggered, rather than performing a probability assessment as required by current GAAP. The basis for that decision was that SACs do not provide a lender with an unfettered right to call the debt and SACs are rarely enforced in practice. This is because when a lender tries to enforce its right to exercise the SAC, U.S. courts often will not uphold the SAC. Accordingly, many lenders consider SACs to be another type of debt covenant. PCC members expressed support for the Board's decision on SACs. If the Board undertook a targeted approach, current GAAP could be amended to make that same improvement.

60. However, current GAAP, which would for the most part be retained under Alternative C, also has specific guidance relating to the existence of SACs in lock-box arrangements. That guidance would be removed on the basis of the Board's decisions in this project and the fact that those types of debt arrangements would be subject to the Board's classification principle. Under a targeted approach, the Board would need to consider how SACs should be treated within the guidance on lock-box arrangements. For example, should borrowings with both a SAC and a lock box be required to be classified as current regardless of the probability of the SAC being triggered? Or, should borrowings with both a SAC and a lock box be required to be classified as noncurrent if the lock box is springing and it is not probable that the SAC will be triggered? A modification to this area of the guidance could increase the complexity in this area. In addition, targeted changes in this area could result in inconsistencies in the guidance on SACs in relation to lock-box arrangements and the general guidance on SACs.

61. Lastly, current GAAP precludes consideration of a financing agreement that has a SAC as a refinancing, meaning the debt in question would be classified as current. Under a targeted approach, the Board would need to reconsider whether to retain or amend that guidance. Retaining that existing GAAP would be inconsistent with the Board's decision to consider SACs when triggered, because the sheer existence of a SAC in a financing agreement affects the classification of current debt.

Waivers of Debt Covenant Violations

62. PCC members also suggested clarifications to the guidance for the probability assessment of debt covenant violations when a covenant has been violated as of the balance sheet date but a waiver is received after that date. During the August education session, several PCC members commented that there is diversity in practice relating to the performance of the probability assessment and that areas of the guidance may be contradictory and should be clarified. The staff has performed outreach with accounting firms and did not identify diversity in the application of that guidance.

63. However, it is possible that there is diversity in how small- or medium-sized firms apply the guidance. In fact, during the education session, some PCC members disagreed with each other's interpretations of the guidance for when the probability assessment is required, indicating that there is some diversity. If the Board were to consider targeted changes to the probability assessment, there would be several potential paths:

    (a) Under current GAAP, the staff's understanding is that the probability assessment is not required to be performed until a violation occurs. The Board could consider the classification for certain scenarios and provide additional guidance using examples. For example, should debt be classified as current if there is no covenant violation as of the balance sheet date, but it is probable that the entity will violate one or more covenants within the next 12 months (the staff believes this would be classified as noncurrent today)?

    (b) The Board could clarify which covenants need to be assessed once a covenant is violated. For example, some PCC members had differing views on whether only the violated covenant should be assessed. Conversely, some PCC members thought that once one covenant is violated, the probability assessment should be performed for all covenants.

    (c) Depending on the path taken on the first set of targeted areas (subsequent event items, including prepayments, etc.), the project scope also could include whether the probability assessment for debt covenant violations should be considered as of 12 months from the balance sheet date or as of 12 months from the financial statement issuance date.

64. Above, the staff has described several potential targeted areas under Alternative C. Because the current focus of the project has been to create an overriding principle, the staff would need to perform additional analysis and research to identify a complete inventory of potential areas as well as to fully develop alternatives for each of the areas. A significant disadvantage of this approach is that it will be difficult for the staff to develop alternatives for targeted changes without having an underlying and consistent basis on which to hinge the changes. A risk is that a targeted approach could result in additional complexities and inconsistencies in the classification guidance and cause confusion for financial statement users.

65. The original objective of the project was to remove all of the narrow-scope debt rules and replace those rules with a principle. That objective would allow the end results to be more easily described and understood by users. Instead, a targeted approach would result in tweaking the current rules or possibly replacing the current rules with different rules. It would be a challenge to describe that approach as being a simplification. In fact, making some of these targeted changes to the existing rules may make the guidance more complicated. In addition, it is difficult to justify which targeted areas should be included and which should be excluded if there is a lack of overarching principle or no basis for making these changes.

Issue 2: Presentation and Disclosure

66. Regardless of the alternative support by the PCC in Issue 1, there are considerations regarding presentation and disclosure for which the Board and staff would like to receive the PCC's input.

67. Throughout the discussions of this project, PCC members have continuously observed that less sophisticated users (such as customers, suppliers, and contract licensors) do not read the notes to the financial statements (also, see paragraphs 18-20 for a summary of outreach performed with the construction industry). This appears to be the basis for several of the PCC's recommendations, such as the views on waivers of debt covenant violations and refinance transactions. That is, PCC members have expressed concerns that financial statement users might draw incorrect conclusions using information on the face of the

financial statements, even though supplemental information describing subsequent transactions is disclosed in the footnotes.

68. In part because of that PCC observation (that many users do not read the footnotes), the Board decided to require separate presentation for debt that is classified as noncurrent because of the receipt of a waiver after the reporting date. Therefore, if an entity receives a waiver after the reporting date, it would present two separate line items for noncurrent debt. For example, an entity would present (a) noncurrent debt because of the receipt of a waiver after the reporting date and (b) all other noncurrent debt.

69. However, in other discussions (on this project and in other projects), PCC members have commented that disclosures can fill gaps in information provided in classification, recognition, and measurement. For example, in the August 29 education session, at least one PCC member suggested that if the Board retained current GAAP on refinances, disclosures could provide users with additional information regarding subsequent transaction.

70. Because of these differing views, the Board and staff would like to better understand the PCC's views on when information should be reflected in the face of balance sheet versus in disclosures, as it relates to debt classification. Understanding the PCC's views on these points will enable the staff to develop a consistent approach for presentation and disclosure of debt classification, regardless of the alternative recommended by the PCC in Issue 1. Understanding these views might assist the Board in deciding whether there should be additional presentation requirements for refinance transactions, similar to its tentative decisions on waivers of debt covenant violations. For example, if the Board decides to retain current GAAP for refinancings, should it consider additional disaggregation in line item presentation (such as noncurrent debt that was contractually current at year-end and subsequently refinanced)?

Issue 3: Accounting for Fees for Post-Balance-Sheet Waivers and Refinances

71. As a result of the PCC's feedback on the operational difficulties of receiving a waiver of a debt covenant violation before the balance sheet date, the Board decided to provide an

exception to the proposed classification principle to require consideration of waivers received after the balance sheet date but before financial statement issuance. During the external review process, some questions arose regarding the period in which the fee related to the waiver should be recorded. For example, if the Board decides to pursue Alternative C to retain GAAP with certain changes to targeted areas, should the Board consider requiring the accrual of the refinancing fees at the balance sheet date? The staff's understanding is that these fees are not currently accrued.

72. Intuitively, it seems desirable to have consistency when a waiver is reflected. That is, if the waiver (or refinance) matters for classification purposes, then it also should matter for recognition and measurement purposes and, therefore, entities should accrue the fee. That is, if a transaction is considered to be a Type 1 (recognized) subsequent event, then all aspects of the transaction should be reflected, including the recognition of the associated fees. A consideration in answering this question is whether the fees meet the definition of a liability; more specifically, whether the entity has a present obligation to transfer assets.

Discussion Questions for the PCC

1. In Issue 1, which Alternative do PCC members support?

1a. If PCC members support Alternative C, which targeted areas (in paragraphs 51-65) do PCC members support including within the project? If only selected areas, what is the underlying basis for addressing certain targeted areas but not others?

2. Do PCC members agree that a private company alternative would not be appropriate, on the basis of the Private Company Decision-Making Framework (see staff analysis in paragraphs 43-44)?

3. On Issue 2, what is the PCC's view on when information should affect classification vs. disclosure for debt classification?

4. On Issue 3, what is the PCC's view on the accounting for fees for waivers and refinances that are incurred after the balance sheet date but before financial statement issuance?

Appendix A

Simplifying the Balance Sheet Classification of Debt
Tentative Board Decisions to Date during Initial Deliberations

August 13, 2014

The Board decided to add this project to the technical agenda as part of its Simplification Initiative.

January 28, 2015

Classification Principle

The Board decided that an entity should classify a debt as noncurrent if one or both of the following criteria are met as of the balance sheet date:

1. The liability is contractually due to be settled more than 12 months (or operating cycle, if longer) after the balance sheet date.
2. The entity has a contractual right to defer settlement of the liability for at least 12 months (or operating cycle, if longer) after the balance sheet date.

The Board decided that decisions about the classification of debt should be made on the basis of facts and circumstances that exist as of the reporting date (that is, as of the balance sheet date).

Scope

The Board decided that the scope of the guidance should apply to all debt arrangements.

July 29, 2015

Scope

The Board decided to clarify that convertible debt instruments and liability-classified mandatorily redeemable financial instruments are included in the scope of the proposed guidance.

Subjective Acceleration Clauses

The Board agreed that under the proposed classification principle, subjective acceleration clauses affect the classification of the debt when triggered.

Waiver of Debt Covenant Violations

The Board decided to provide an exception to the classification principle for waivers of debt covenant violations received after the reporting date but before financial statements are issued. The exception would apply to all waivers, except for those that result in a debt modification or an extinguishment (as defined in Subtopic 470-50, Debt—Modifications and Extinguishments). This exception would retain the probability assessment that is performed under existing (GAAP) in paragraph 470-10-45-1(b). The Board also decided to require separate presentation in the balance sheet for debt that is classified as noncurrent as a result of this exception.

Recurring Disclosures

The Board decided to require disclosure of debt covenant violations and disclosure of significant subjective acceleration clauses and debt covenants.

Transition and Transition Disclosures

The Board decided that in the first interim and annual financial statements following the effective date, an entity would apply the proposed amendments on a prospective basis to all debt that exists as of that date. The Board also decided that the following transition disclosures on Topic 250, Accounting Changes and Error Corrections, should be required:

1. The nature of and reason for the change in accounting principle

2. The effect of the change on affected financial statement line items in the current period.

Next Steps
The Board directed the staff to draft guidance in a proposed Accounting Standards Update for vote by written ballot, with a comment period of 60 days.