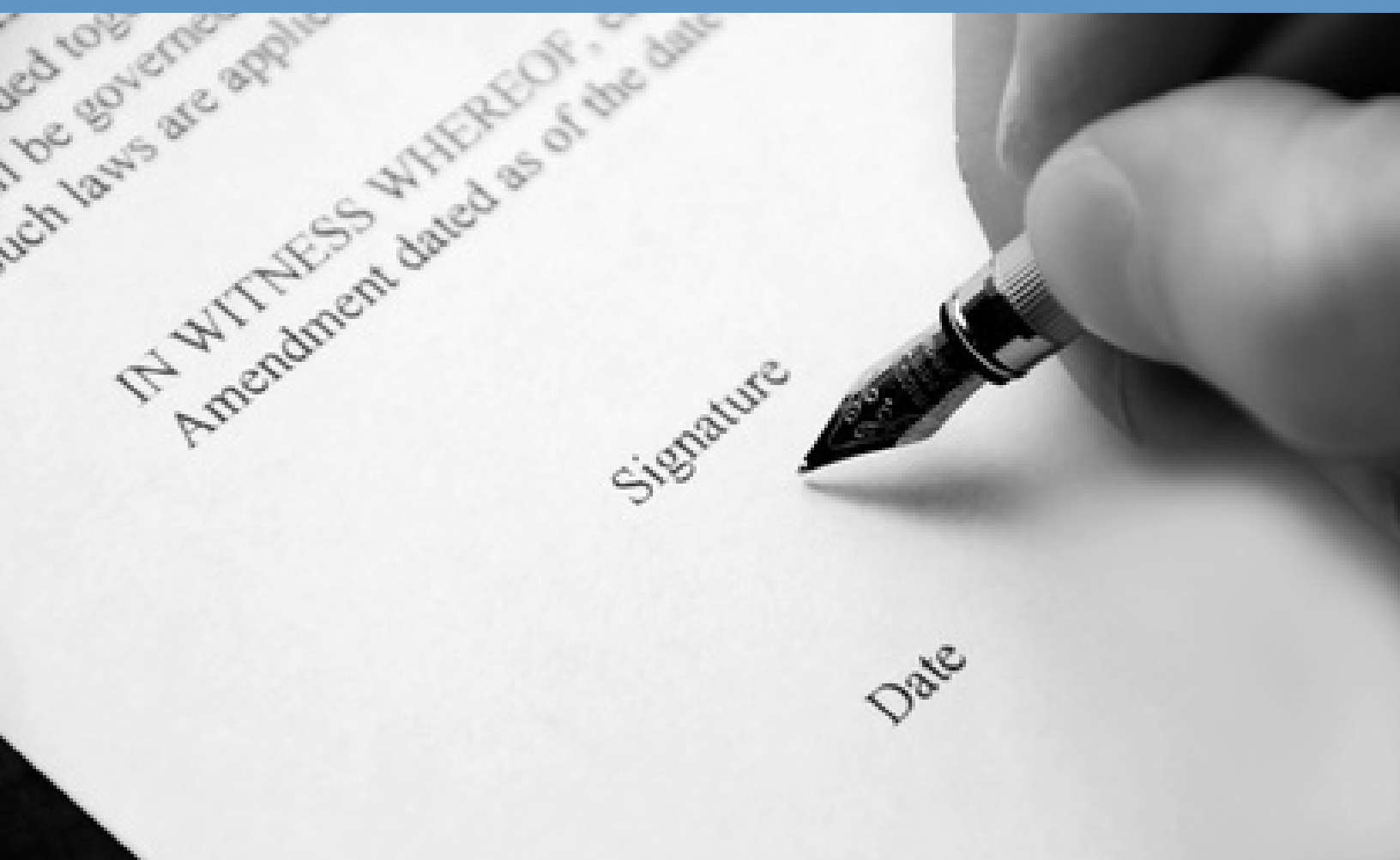


**McGladrey & Pullen**

Certified Public Accountants



Fundamentals of Debt Classification

National Professional Standards Group

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## A. Introduction

The current economic environment is forcing many borrowers to take a fresh look at the factors that led them to classify their debt as either current or noncurrent when preparing a classified balance sheet. Seemingly straightforward debt agreements sometimes contain terms that can cause surprising classification issues. Furthermore, with the increased frequency of covenant violations in the current economic environment, both the terms and the form of any covenant waivers require careful analysis by borrowers to determine whether and how such waivers should affect the classification and disclosure of the related debt. A few of the more common issues and factors to consider when determining the appropriate classification of debt include the following:

- *If a debt covenant has been violated at the balance-sheet date and a waiver has been obtained from the lender for this violation, how is the underlying debt classified?* Many borrowers are finding they are in violation of one or more debt covenants at the balance-sheet date. A borrower may or may not be able to obtain a waiver for its violation of these debt covenants. In addition, the waiver may or may not affect the borrower's classification of the underlying debt.
- *How does a subjective acceleration clause affect the classification of the underlying debt?* Due to the increased likelihood of "material adverse changes" (a common subjective acceleration clause) as the current recession drags on, the likelihood that a subjective acceleration clause will be exercised by a lender has increased. This increased likelihood has repercussions on the borrower's classification of the underlying debt.
- *When the lender requires the borrower to have a lock-box arrangement in connection with a revolving credit agreement, how does that arrangement affect the classification of any borrowings under the revolver?* To protect themselves, many lenders include a lock-box arrangement in their revolving credit agreements. The terms of the lock-box arrangement could affect the borrower's classification of the borrowings under the revolver.
- *How does a due-on-demand clause affect the classification of the underlying debt?* Nearly every week, more bank closures are announced. Lenders are experiencing liquidity and regulatory capital difficulties in today's economic environment and it is common for lenders to include due-on-demand clauses in their debt agreements. Such clauses provide lenders with the ability to require payment on an accelerated basis because of concerns related to the lender's or borrower's financial condition. Due-on-demand clauses affect the classification of the underlying debt.
- *How does expected long-term refinancing affect the classification of what would otherwise be considered a short-term obligation?* Many borrowers find themselves in a position in which they are unable to make payments on obligations that are coming due in the short-term. As a result, attempts are made to refinance these short-term obligations on a long-term basis. If the borrower is successful in negotiating long-term refinancing after the balance-sheet date, but before its financial statements are issued or available to be issued, the classification of the short-term obligation to be refinanced on a long-term basis may be affected.

Proper classification of debt as current or noncurrent is important for a variety of reasons. Debt covenants often involve measures that are affected by the current or noncurrent classification of debt (e.g., working capital). As such, properly classifying debt as current or noncurrent could affect a borrower's assessment of whether it has violated its debt covenants. Potential lenders also focus on the current or noncurrent classification of debt in assessing a potential borrower's liquidity and the risk involved in lending to that borrower. A surety providing a performance bond would also focus on the current or noncurrent classification of debt in assessing the borrower's liquidity and determining the fees for its service. A borrower's auditors will focus on classification of debt as current or noncurrent in determining whether the borrower is a going concern. Rating agencies will focus on classification of debt as current or noncurrent in determining the appropriate credit rating for a borrower. Potential lenders, sureties, auditors, and

rating agencies represent only some of the parties that have an interest in the borrower properly classifying debt as current or noncurrent.

Prior to the Financial Accounting Standards Board (FASB) releasing their *Accounting Standards Codification* ©™ (ASC or the *Codification*), the relevant accounting literature on debt classification was scattered throughout a number of different pronouncements. With release of the *Codification*, the relevant accounting literature on the classification of debt as current or noncurrent has been combined into primarily two sections of the *Codification*:

- ASC 210-10-45, "Presentation – Balance Sheet – Overall – Other Presentation"; and
- ASC 470-10, "Debt – Overall."

The relevant guidance in these sections of the *Codification* has been summarized in this paper in Part B, "Relevant Literature and General Concepts." The relevant section(s) of the *Codification* are listed in Part B as is the relevant predecessor literature. A key to the predecessor literature is included in this paper in Part D, "Pre-Codification Source Literature Listing." Numerous examples of how to apply the relevant guidance in the *Codification* are included in this paper in Part C, "Examples."

When applying the guidance discussed in Part B, it is necessary to determine the timeframe used to designate liabilities as current or noncurrent. As discussed in the "Current Liabilities" topic of Part B, that timeframe is 12 months or, if longer, the entity's operating cycle. For simplicity purposes, we refer just to the 12 months (or one year) timeframe in this paper. In addition, the guidance discussed in Part B only affects the balance sheet if an entity presents a *classified* balance sheet. However, the table of debt maturities that must be included in the disclosures that accompany the financial statements is affected by this guidance even when a classified balance sheet is not presented.

## B. Relevant Literature and General Concepts

CLASSIFIED BALANCE SHEET			
Relevant Codification Section(s)	210-10-45-5	Pre-Codification Source	FAS 6, par. 15
General Concepts			
When a classified balance sheet is presented, a total for current liabilities must be shown.			

CURRENT LIABILITIES			
Relevant Codification Section(s)	210-10-45-9 210-10-45-12	Pre-Codification Source	ARB 43, Ch. 3A, pars. 7 and 8
General Concepts			
<p>Current liabilities include those other liabilities that are expected to be paid (i.e., liquidated) within a relatively short period of time. The period of time used in making this determination is usually 12 months (or, if longer, the entity's operating cycle). Examples of other liabilities that fall within the current classification include: (a) short-term debts undertaken to acquire capital assets; (b) serial maturities of long-term debt; and (c) sinking fund expenditures expected to occur within one year.</p> <p>Current liabilities are not intended to include debts that will be funded or extinguished using accounts that are not considered current assets. In addition, current liabilities are not intended to include long-term obligations that are expected to supplement working capital for long periods of time. Said differently, designating a liability as "current" means that the extinguishment of that liability is reasonably expected to require: (a) use of existing current assets or (b) incurring other current liabilities.</p>			

VIOLATION OF DEBT COVENANTS			
Relevant Codification Section(s)	470-10-45-1 470-10-55-2 thru 6	Pre-Codification Source	EITF 86-30
General Concepts			
<p>When violation of a debt covenant gives the lender the right to call the debt, such violation should typically result in the classification of the debt as current by the borrower. However, the lender may waive its right to call the debt for a period of greater than one year while retaining its right to act on covenant violations that occur after the waiver period. In these cases, the debt should be classified as noncurrent by the borrower unless: (a) the covenant violation occurred at the balance-sheet date or would have occurred without the lender and borrower agreeing to modify the loan <i>and</i> (b) the borrower is not expected to (i.e., it is not probable that the borrower will) be able to comply with the covenant at compliance dates that occur within the next 12 months.</p> <p>Examples of debt covenants include: (a) maintenance of a minimum current ratio, maximum debt to equity ratio, minimum level of stockholders' equity and (or) minimum fixed charge coverage ratio; (b) prohibition from incurring or maintaining indebtedness in excess of a specified amount; (c) prohibition from annual capital expenditures above a specified amount; and (d) maintenance of a minimum amount of earnings before interest, taxes, depreciation and amortization (EBITDA) for quarterly or annual periods.</p> <p>If application of this guidance results in noncurrent classification, disclosure of probable future noncompliance with debt covenants may still be required.</p> <p><b>Commentary:</b> In considering whether a waiver should affect the classification of debt as current or noncurrent, the substance of the waiver should be evaluated (i.e., only substantive waivers should affect classification of debt as current or noncurrent). For example, a substantive waiver should be in writing (i.e., oral waivers are likely not</p>			

substantive). Waivers in the form of an email message may or may not be substantive. The borrower's legal counsel should be involved in that determination. A substantive waiver has been approved by a loan officer with appropriate authority to grant the waiver and negotiate the terms of the waiver.

Judgment must be exercised in assessing the probability of the borrower being able to comply with covenants in the future. There must be objective support for the conclusion reached. In addition, the borrower should consider: (a) whether the conclusion reached is consistent with its historical ability to comply with covenants and (b) whether the borrower has been able to accurately predict its ability to comply with covenants in the past.

A borrower should not disregard the effects of a covenant violation based on: (a) it being unlikely that the lender will enforce the covenant or (b) it being the lender's historical practice to not enforce covenants.

SUBJECTIVE ACCELERATION CLAUSE			
Relevant Codification Section(s)	470-10-45-2 470-10-50-3	Pre-Codification Source	FTB 79-3
General Concepts			
<p>When a debt agreement includes a subjective acceleration clause, the lender is allowed to accelerate payment under the debt agreement based on subjective criteria. In other words, the lender is allowed to accelerate payment without pointing to the failure of a specific, objective debt covenant. An example of a subjective acceleration clause is when the lender is allowed to accelerate payment under the debt agreement if a material adverse change occurs. Whether a material adverse change has occurred is a subjective (not an objective) determination. When a subjective acceleration clause is included in a debt agreement, the classification of the underlying obligation as current or noncurrent by the borrower depends on the likelihood of the lender exercising its rights under the subjective acceleration clause. If the likelihood is remote that the lender will exercise its rights, then classification as noncurrent is appropriate. If the likelihood is more than remote, then the borrower would need to consider whether classification as current and (or) disclosure is appropriate under the circumstances.</p> <p><b>Commentary:</b> Judgment must be exercised in assessing the likelihood of the lender exercising its rights under a subjective acceleration clause. There must be objective support for the conclusion reached. In addition, the borrower should consider: (a) whether the conclusion reached is consistent with the lender's past practice with respect to exercising its rights under subjective acceleration clauses; (b) whether the borrower has been able to accurately predict the likelihood of a lender exercising its rights under subjective acceleration clauses in the past; and (c) how the current lending conditions might affect the borrower's ability to assess the likelihood of the lender exercising its rights under a subjective acceleration clause under current lending conditions (e.g., is the borrower's ability to make the assessment in the past truly indicative of its ability to make the assessment today).</p>			

REVOLVING CREDIT AGREEMENTS			
Relevant Codification Section(s)	470-10-45-3 thru 6	Pre-Codification Source	EITF 95-22
General Concepts			
<p>The classification of a revolving credit agreement as current or noncurrent depends on a number of factors:</p> <ul style="list-style-type: none"> <li>• Are borrowings under the revolving credit agreement due at the end of a specified period that extends beyond one year from the balance-sheet date (i.e., is the principal only due at maturity and is the maturity date more than one year from the balance-sheet date or does the principal not roll over until more than one year past the balance-sheet date)? <ul style="list-style-type: none"> <li>– If so, classify the borrowings as noncurrent. The effects of lock-box arrangements and subjective acceleration clauses are assessed separately and may result in current classification (see bullet points that follow).</li> </ul> </li> </ul>			

- Are the borrowings under the revolving credit agreement due when the underlying short-term notes roll over?
  - If so, are the short-term notes automatically replaced with other short-term notes upon their maturity and does this rollover process extend beyond one year?
    - ◆ If so, classify the borrowings as noncurrent if the revolving credit agreement meets the criteria in ASC 470-10-45-14b (i.e., those criteria used to classify as noncurrent a short-term obligation that the borrower intends to refinance on a long-term basis). The effects of lock-box arrangements are assessed separately and may result in current classification (see bullet points that follow).
    - ◆ If not, classify the borrowings as current.
- Does the revolving credit agreement include a lock-box arrangement? If so:
  - Is the lock-box arrangement maintained at the borrower's discretion?
    - ◆ If so, the existence of the lock-box arrangement does not otherwise affect the classification of the borrowings.
  - Does the lock-box arrangement require cash received in the lock-box account in the ordinary course of business to be used to repay the borrowings without another event occurring (i.e., repayment of the borrowings with the lock-box proceeds happens automatically and contractually)?
    - ◆ If so, classify the borrowings as current unless the revolving credit agreement meets the criteria in ASC 470-10-45-14b (i.e., those criteria used to classify as noncurrent a short-term obligation that the borrower intends to refinance on a long-term basis). If the revolving credit agreement includes a subjective acceleration clause, it will fail one of the criteria in ASC 470-10-45-14b regardless of the likelihood of the subjective acceleration clause being triggered. This failure would result in the borrowings being classified as current unless the borrower intended to enter into another long-term refinancing arrangement that satisfied the criteria in ASC 470-10-45-14.
  - Does the lock-box arrangement result in cash received in the lock-box account being used to repay the borrowings only if another substantive event occurs (e.g., in a springing lock-box arrangement, the cash received in the lock-box account is only used to repay the borrowings if there is a subjective acceleration clause that is triggered by the lender)?
    - ◆ If so, the existence of the lock-box arrangement does not otherwise affect the classification of the borrowings.
    - ◆ If so, does the revolving credit agreement include a subjective acceleration clause?
      - If so, consider whether the exercise of the subjective acceleration clause is remote or more than remote (see the "Subjective Acceleration Clause" topic in Part B).
        - If it is remote that the subjective acceleration clause will be exercised, classify the borrowings as noncurrent.
        - If it is more than remote that the subjective acceleration clause will be exercised, consider whether the borrowings should be classified as current and whether disclosure of the subjective acceleration clause is necessary.

The following chart provides various scenarios involving a revolving credit agreement *that would otherwise be classified as noncurrent* if not for the inclusion of a lock-box arrangement and (or) a subjective acceleration clause (SAC):

Lock-Box	SAC	Current or Noncurrent?
No	No	Noncurrent
No	Yes	Depends on whether it is remote that the lender will exercise its rights under the clause
Traditional	No	Noncurrent
Traditional	Yes	Current
Springing	Yes	Depends on whether it is remote that the lender will exercise its rights under the clause

For purposes of this chart, a traditional lock-box arrangement is one in which cash received in the lock-box account in the ordinary course of business is required to be used to repay the borrowings without another event occurring (i.e., repayment of the borrowings with the lock-box proceeds happens automatically and contractually).

DUE ON DEMAND LOAN AGREEMENT			
Relevant Codification Section(s)	470-10-45-9 thru 10	Pre-Codification Source	ARB 43, Ch 3A, par. 7 EITF 86-5
General Concepts			
<p>If a loan agreement is due on demand or could be due on demand within one year of the balance-sheet date, classification of any borrowings under the agreement should be current. Expectations about whether the lender will demand payment within one-year of the balance-sheet date do not affect the determination as to whether current classification is appropriate. This differs from the considerations involved in determining the classification effects of a subjective acceleration clause because when a loan is due on demand the lender has sole discretion to demand payment at any time without having to have even a subjective basis to do so.</p>			

CALLABLE OBLIGATION			
Relevant Codification Section(s)	470-10-45-11 thru 12 470-10-50-2	Pre-Codification Source	ARB 43, Ch 3A, par. 7 FAS 78
General Concepts			
<p>Under certain circumstances, a callable obligation gives the lender the right to: (a) demand repayment from the borrower or (b) give notice that the lender intends to demand repayment from the borrower. An obligation may become callable because the borrower violated a provision of the underlying debt agreement or because the borrower is not expected to cure the violation of a provision in the underlying debt agreement during a specified grace period. The borrower classifies these callable obligations as current unless: (a) the lender waives or otherwise loses the right to demand repayment from the borrower for more than one year from the balance-sheet date or (b) it is probable that, during the grace period, the borrower will cure the violation that would otherwise cause the obligation to become callable. One way in which a lender can otherwise lose its right to demand repayment from the borrower is if the borrower cures the violation after the balance-sheet date and curing the violation results in the lender no longer having the right to call the debt as of the date the financial statements are issued or available to be issued. For purposes of identifying provisions that have been violated, the perceived "significance" of the violation is not considered. In other words, there are not some violations that matter from a classification perspective and others that do not matter from a classification perspective.</p> <p>There is different classification guidance for obligations that are "due on demand" and those that are "callable" because a "callable" obligation only becomes due on demand in certain circumstances (e.g., the borrower violated a provision of the underlying debt agreement).</p> <p>If a callable obligation is classified as noncurrent in the balance sheet or footnote disclosures, the circumstances giving rise to the noncurrent classification must be disclosed.</p> <p><b>Commentary:</b> Judgment must be exercised in assessing the probability that, during the grace period, the borrower will cure the violation that would otherwise cause the obligation to be callable. There must be objective support for the conclusion reached. In addition, the borrower should consider: (a) whether the conclusion reached is consistent with its historical ability to cure violations during the grace period and (b) whether the borrower has historically been able to accurately predict its ability to cure violations during the grace period.</p>			

## EFFECTS OF EXPECTED LONG-TERM REFINANCING ON CLASSIFICATION OF SHORT-TERM OBLIGATIONS

Relevant Codification Section(s)	470-10-45-12A thru 20 470-10-50-4 470-10-55-13 thru 36	Pre-Codification Source	FAS 6 FIN 8
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### General Concepts

A borrower may intend to refinance a short-term obligation on a long-term basis. To accomplish this, the borrower would either: (a) replace the short-term obligation with a long-term obligation; (b) replace the short-term obligation with equity securities; or (c) renew, extend, or replace the short-term obligation with short-term obligations for an uninterrupted period that extends beyond the borrower's balance-sheet date by more than one year. A short-term obligation that the borrower intends to refinance on a long-term basis (other than those short-term obligations payable in customary terms arising from transactions in the normal course of business [e.g., trade accounts payable, accrued payroll, etc.]) should be classified as noncurrent if the borrower is able to demonstrate its ability to consummate the long-term refinancing by either:

- Issuing a long-term obligation or equity securities after the borrower's balance-sheet date but before the balance sheet is issued or available to be issued; or
- Entering into a financing agreement before the borrower's balance sheet is issued or available to be issued and **all** of the following are met:
  - The agreement permits refinancing of the short-term obligation on a long-term basis;
  - The agreement includes readily determinable terms;
  - The agreement does not expire within one year of the borrower's balance-sheet date;
  - The agreement is only cancelable within one year of the borrower's balance-sheet date by the party that would provide the financing (e.g., lender or investors) if the borrower violates an objectively determinable or measurable provision of the agreement (otherwise the agreement is not cancelable within one year of the borrower's balance-sheet date by the party that would provide the financing);
  - Any obligation underlying the agreement is only callable within one year of the borrower's balance-sheet date by the party that would provide the financing if the borrower violates an objectively determinable or measurable provision of the agreement (otherwise the underlying obligation is not callable within one year of the borrower's balance-sheet date by the party that would provide the financing);
  - If the borrower has violated a provision in the financing agreement as of or after its balance-sheet date, but before its balance sheet is issued or available to be issued, it has obtained a waiver from the party that would provide the financing (i.e., no "un-waived" violations may exist at the point in time that the balance sheet is issued or available to be issued); **and**
  - The party that would provide the financing has the economic ability to provide the financing (i.e., the lender has the financial where-with-all to provide the financing to the borrower).

If the long-term refinancing involves equity securities, it would **not** be appropriate to classify the short-term obligation being refinanced within equity.

**Commentary:** Given the current lending and regulatory environment, a borrower should be watchful of any publicly available information indicating that the counterparty to a long-term financing agreement (e.g., a financial institution) may not have the economic ability to honor the terms of the financing agreement. Such information must be taken into consideration when determining the appropriate classification of a short-term obligation that the borrower intends to refinance with the long-term refinancing. For example, if the counterparty is a financial institution, it may be appropriate for the borrower to review the counterparty's call reports, any financial information filed with the United States Securities and Exchange Commission (SEC) or bank regulators if the counterparty is a public entity, or any other publicly available information that raises regulatory concerns about the counterparty.

### Evaluation of Objective and Subjective Provisions in the Financing Agreement

For purposes of determining whether the borrower has violated an *objectively* determinable or measurable provision of the financing agreement, a violation is still considered to have occurred even if the agreement provides for a grace period during which the violation can be cured. Without an appropriate waiver, such a violation would result in the financing agreement failing to meet the requirements that must be met to exclude the short-term obligation from current liabilities. To the extent compliance with a provision of the financing agreement can be evaluated differently by the borrower and the party that would provide the financing, that provision is not considered objectively determinable or measurable. Examples of provisions that would not be considered objectively determinable or measurable are clauses having to do with "a material adverse change" or "failure to maintain satisfactory operations." Examples of provisions that would be considered objectively determinable or measurable are: (a) maintaining a certain level of working capital; (b) restrictions on entering into any lease agreements with rentals in excess of a certain amount; (c) restrictions on acquiring treasury stock without the permission of the party that would provide the financing; and (d) restrictions on guaranteeing the indebtedness of unaffiliated persons in excess of a certain amount. If provisions that are not considered to be objectively determinable or measurable exist in the financing agreement, then the agreement would fail to meet the requirements that must be met to exclude the short-term obligation from current liabilities.

### Classification of Funds Received from Long-Term Financing Prior to the Balance-Sheet Date

If long-term financing or the existence of a financing agreement that meets the conditions discussed above is the basis used to classify a short-term obligation as noncurrent and the borrower obtains funds from the long-term financing or the financing agreement before the balance-sheet date, those funds should be excluded from current assets because the short-term obligation is excluded from current liabilities.

### Repayment of Short-Term Obligation Before Obtaining Long-Term Financing

If, after the borrower's balance-sheet date but before the balance sheet is issued or available to be issued, the borrower repays a short-term obligation and subsequently obtains long-term financing, the short-term obligation should be classified as current as of the balance-sheet date.

### Considerations in Determining Amount of Short-Term Obligation to be Classified as Noncurrent

If post-balance-sheet date long-term financing or the existence of a financing agreement that meets the conditions discussed above is the basis used to classify a short-term obligation as noncurrent, consideration should be given to the amount of financing received or available under the agreement. Any excess of the amount of the short-term obligation over the amount of financing received or available under the agreement should be classified as current. Only the amount of the short-term obligation that is covered by the financing received or financing available under the agreement should be classified as noncurrent.

If the existence of a financing agreement that meets the conditions discussed above is the basis used to classify a short-term obligation as noncurrent, the amount reflected as noncurrent should be adjusted to reflect the unavailability of funds under the agreement due to restrictions present in the financing agreement or other agreements. An example where classification of the short-term obligation as noncurrent would be tainted involves a foreign subsidiary negotiating the financing agreement with its local bank, but the terms of the agreement prohibit the transfer of funds outside the country. In addition, in some cases, the amount available under the financing agreement changes period-over-period. For example, the amount available under the financing agreement may vary based on the level of inventory held by the borrower at the end of any given period. When the amount available under the financing agreement fluctuates period-over-period, the borrower should make a reasonable estimate of the minimum amount expected to be available between the short-term obligation's due date and the end of the borrower's fiscal year. If estimable, the amount classified as noncurrent should be limited to this minimum amount. If not estimable, no amount of the short-term obligation should be classified as noncurrent.

**Commentary:** Judgment must be exercised in determining whether a reasonable estimate can be made of the minimum amount expected to be available between the short-term obligation's due date and the end of the

borrower's fiscal year. There must be objective support for the conclusion reached. In addition, the borrower should consider whether it has been able to accurately estimate the minimum amount in the past.

#### Alternative Sources of Financing

The borrower may put in place a financing agreement that meets the conditions discussed above and use that agreement as the basis to classify a short-term obligation as noncurrent while working to obtain an alternative source of financing that would be in place at the time the short-term obligation actually matures. Undertaking these efforts to obtain an alternative source of financing only taints classification of the short-term obligation as noncurrent if the borrower does not intend to use the "in-place" financing agreement if the alternative source of financing does not come through. In assessing the borrower's intent to use the in-place financing agreement that serves as the basis to classify a short-term obligation as noncurrent, the reasonableness of the terms in the financing agreement should be considered. If the in-place financing agreement contains unreasonable terms (e.g., excessive interest rate charges or collateral requirements) that might affect the borrower's ultimate decision to exercise its rights under the in-place financing agreement, then there may not be sufficient intent present to support classification of the short-term obligation as noncurrent.

#### Replacement of Short-Term Obligations with Other Short-Term Obligations

As mentioned earlier, a borrower may intend to refinance a short-term obligation on a long-term basis by renewing, extending, or replacing the short-term obligation with other short-term obligations for an uninterrupted period that extends beyond the borrower's balance-sheet date by more than one year. These "replacement" short-term obligations (e.g., revolving credit agreement; rollover of commercial paper accompanied by a standby credit agreement) must meet the same conditions that any other financing agreement must meet for the borrower to classify the short-term obligation as noncurrent at its balance-sheet date. One of the critical factors in this analysis is the *borrower* having the option to continuously renew the short-term obligations.

#### Disclosures

To the extent a borrower classifies a short-term obligation as noncurrent in its balance sheet as a result of meeting the conditions discussed earlier, the borrower should disclose a description of the financing and its terms.

## DEBT DISCLOSURES

**Commentary:** The *Codification* requires a relatively limited number of disclosures about the debt taken on by an entity. A few of these disclosure requirements have been noted in this paper. The SEC requires more disclosures about the debt taken on by public companies. In the absence of a specific disclosure requirement, a borrower should still consider whether the users of its financial statements would be interested in, or influenced by, information pertaining to the entity's debts. For example, even though there is not a specific requirement that calls for the disclosure of all waivers received for debt covenant violations, the borrower should still consider whether the users of its financial statements would find information about the waivers to be helpful and relevant. In doing so, the borrower may conclude that it is not necessary to provide disclosures about a waiver received for the violation of a covenant that limits capital expenditures to a specific amount if the borrower only overspent on capital expenditures by a minor amount. However, the borrower may conclude that it is necessary to disclose information about a waiver received for violating a covenant that requires maintaining a certain debt-to-equity ratio because the borrowings are significant or because there is uncertainty as to whether it will be able to maintain an adequate debt-to-equity ratio in the future. In general, if the user of the financial statements would be influenced by information pertaining to the entity's debts (e.g., specific terms of the debt; specific debt covenants; degree of compliance with debt covenants; and expectations about compliance with debt covenants in the future), then such information should be disclosed. The extent of the disclosures will vary depending on the facts and circumstances.

## C. Examples

For purposes of the examples included herein, assume that Borrower presents a classified balance sheet on an annual basis as of December 31<sup>st</sup> and that the time period used by Borrower in classifying an asset or liability as current is 12 months. Also, assume that Borrower issues its financial statements on the March 31<sup>st</sup> that follows the balance-sheet date.

### 1. Covenant Compliance Waiver on Debt Covenant Violation at Balance-Sheet Date

**Facts:** Borrower has a long-term loan that includes debt covenants. Borrower must comply with these debt covenants on a quarterly basis. Borrower determines that it is in violation of a covenant as of December 31, 20X0. Borrower obtains a covenant compliance waiver from Lender that waives Lender's right to call the debt for a period of one year and one day. Lender retains its right to act on covenant violations that occur after the waiver period. It is probable that Borrower will be able to comply with the covenant by the next compliance date (March 31, 20X1) and remain in compliance with the covenant for each of the compliance dates within the waiver period. Borrower is able to objectively support and explain these predictions. Should the long-term loan be classified as current or noncurrent in Borrower's December 31, 20X0 balance sheet?

**Analysis:** Noncurrent classification is required by Borrower as of December 31, 20X0 because it is probable that Borrower will be able to comply with the covenants at each compliance date that occurs within the waiver period, which exceeds 12 months.

### 2. Debt Covenant Violation Expected After Balance-Sheet Date

**Facts:** Borrower has a long-term loan that includes debt covenants. Borrower must comply with these debt covenants on a quarterly basis. Borrower determines that it is in compliance with the debt covenants as of December 31, 20X0. However, it is probable that Borrower will not be in compliance with the debt covenants as of March 31, 20X1. Should the long-term loan be classified as current or noncurrent in Borrower's December 31, 20X0 balance sheet?

**Analysis:** Noncurrent classification is required by Borrower as of December 31, 20X0 because Borrower was in compliance with its covenants at the balance-sheet date. However, Borrower is required to disclose in its 20X0 financial statements its probable future noncompliance with the debt covenants.

### 3. Covenant Compliance Waiver on Debt Covenant Violation at Balance-Sheet Date and Subsequent Compliance Date

**Facts:** Borrower has a long-term loan that includes debt covenants. Borrower must comply with these debt covenants on a quarterly basis. Borrower determines that it is in violation of a covenant as of December 31, 20X0. Borrower obtains a substantive covenant compliance waiver from Lender that waives Lender's right to call the debt for a period of one year and one day. Lender retains its right to act on covenant violations that occur after the waiver period. It is not probable that Borrower will be able to comply with the covenant by the next compliance date (March 31, 20X1), but it is probable that Borrower will be able to comply with the covenant for the remaining compliance dates within the waiver period (June 30, 20X1, September 30, 20X1, and December 31, 20X1). Borrower is able to objectively support and explain these predictions. Should the long-term loan be classified as current or noncurrent in Borrower's December 31, 20X0 balance sheet?

**Analysis:** Current classification is required by Borrower as of December 31, 20X0 because the covenant violation occurred as of the balance-sheet date and it is probable that Borrower will not be able to comply with the debt covenants at all of the measurement dates that occur within the next 12 months.

The waiver in this situation was obtained for a discrete event (i.e., noncompliance with a debt covenant at December 31, 20X0). When considering the effects of this waiver on the classification of the long-term loan as current or

noncurrent, subsequent compliance with debt covenants in the following year must be considered because those are different discrete events for which the Lender has not waived its rights. Because it is probable that Borrower will not be able to comply with all of the discrete events occurring within the following year (i.e., Borrower does not expect to comply with the covenant at March 31, 20X1) and Lender has not waived its rights to act upon any noncompliance as those discrete events occur, Borrower must classify the long-term debt as current. If Lender provided Borrower with a grace period during which Borrower could cure noncompliance with the debt covenant, then the grace period would need to be taken into consideration in determining the appropriate classification for the long-term debt. In this particular fact pattern, the length of any grace period provided by Lender would likely factor into the decision about whether current or noncurrent classification was appropriate. In other words, if the grace period covered 30 days and it was not probable that Borrower would be in compliance with the debt covenant within those 30 days, then current classification at December 31, 20X0 would be appropriate. However, if the grace period covered 180 days and it was probable that Borrower would be in compliance with the debt covenant within those 180 days, then noncurrent classification at December 31, 20X0 would be appropriate.

#### 4. Modification to Remove Debt Covenant Compliance for Current Balance-Sheet Date with Violation Expected at Subsequent Compliance Date

**Facts:** Borrower has a long-term loan that includes debt covenants. Borrower must comply with these debt covenants on a quarterly basis. Borrower determines that it is in compliance with the debt covenants at September 30, 20X0. However, Borrower does not expect to be in compliance with the debt covenants as of December 31, 20X0. As such, Borrower negotiates with Lender to modify the loan to eliminate the need to meet the debt covenants at December 31, 20X0. Without this modification, Borrower would have violated the covenants at the balance-sheet date. While the debt covenants did not apply at the balance-sheet date due to the loan modification, the debt covenants would continue to apply at the subsequent quarterly compliance dates (e.g., March 31, 20X1). It is not probable that the debt covenants will be met at the subsequent quarterly compliance dates. Should the long-term loan be classified as current or noncurrent in Borrower's December 31, 20X0 balance sheet?

**Analysis:** Current classification is required by Borrower as of December 31, 20X0 because: (a) a debt covenant violation would have occurred absent the loan modification and (b) it is not probable that Borrower will be able to comply with the debt covenants at all of the measurement dates that occur within the next 12 months.

#### 5. Subjective Acceleration Clauses

**Facts:** Borrower has a long-term loan that allows Lender to accelerate payment if either: (a) Borrower fails to maintain satisfactory operations or (b) a material adverse change occurs. If Lender exercises its right to accelerate payment under either of these clauses, Borrower must repay all amounts due under the loan within 90 days of notification by Lender. Borrower asserts that the likelihood of Lender exercising its rights under either of these clauses in 20X1 is determined to be remote. Borrower is able to objectively support and explain this assertion. The only other loan covenants address standard items, such as being current on payments. Borrower was not in violation of any of these other covenants on December 31, 20X0. Should the long-term loan be classified as current or noncurrent in Borrower's December 31, 20X0 balance sheet?

**Analysis:** Noncurrent classification is required by Borrower as of December 31, 20X0. The clauses that permit Lender to accelerate payment either because Borrower fails to maintain satisfactory operations or because a material adverse change occurs are referred to as subjective acceleration clauses. Because the clauses are subjective, Borrower must consider the likelihood of Lender exercising its rights under either of the clauses during 20X1. Given that Borrower thinks it is remote that Lender will exercise its rights under either of these clauses during 20X1 (and Borrower is able to support and explain this assertion), noncurrent classification is appropriate. If Borrower thought it was more than remote that Lender would exercise its rights under one of these clauses during 20X1, Borrower would need to consider whether current classification and (or) disclosure would be appropriate under the circumstances.

## 6. Revolving Credit Agreement Used to Supplement Working Capital

**Facts:** Borrower entered into a revolving credit agreement on September 1, 20X0. The revolver has a three-year term and the maximum that can be borrowed under the revolver is \$50 million. The revolving credit agreement permits, over the term of the loan, a series of renewals or extensions that individually are for periods of less than one year (e.g., 90 days). As such, the short-term obligation is being refinanced with other short-term obligations until the end of the revolving credit agreement's term. Interest payments on outstanding principal are due on a monthly basis. Amounts borrowed under the revolver are used to supplement working capital due to seasonal fluctuations. There are no loan covenants other than standard items, such as being current on payments. Borrower was not in violation of any of these covenants on December 31, 20X0. At December 31, 20X0, the outstanding principle borrowed on the revolver is \$12 million. How should the outstanding principle borrowed on the revolver be classified in Borrower's December 31, 20X0 balance sheet?

**Analysis:** Because the revolving credit agreement effectively provides long-term financing through the continuous refinancing of the short-term obligation with other short-term obligations over the term of the revolving credit agreement, the amounts borrowed under the revolving credit agreement at December 31, 20X0 should be excluded from current liabilities if the revolving credit agreement meets the conditions included in Section 470-10-45-14b of the *Codification* for classifying as noncurrent a short-term obligation that the borrower intends to refinance on a long-term basis using a financing agreement. For purposes of this example, assume that Borrower meets those conditions. As such, Borrower should classify the principle balance due on the revolver (\$12 million) as noncurrent as of December 31, 20X0. Noncurrent classification is required because Borrower is effectively not obligated to make a principle payment on the revolver until August 31, 20X3. The fact that the revolver is used to supplement working capital (the components of which are classified as current on a classified balance sheet), does not affect the noncurrent classification of the outstanding principle balance on the revolver because the conditions included in Section 470-10-45-14b of the *Codification* are met.

## 7. Revolving Credit Agreement with Borrowing Base

**Facts:** Borrower entered into a revolving credit agreement on September 1, 20X0. The revolver has a three-year term and the maximum that can be borrowed under the revolver is the lesser of: (a) \$25 million and (b) the total of (i) 75% of the eligible accounts receivable balance and (ii) 50% of finished goods inventory, capped at \$7 million. Amounts borrowed in excess of the maximum borrowing base at any quarterly balance-sheet date are due within 30 days of that date. Otherwise, the revolving credit agreement permits, over the term of the loan, a series of renewals or extensions that individually are for periods of less than one year (e.g., 90 days). As such, the short-term obligation is being refinanced with other short-term obligations until the end of the revolving credit agreement's term. The revolving credit agreement meets the conditions included in Section 470-10-45-14b of the *Codification* for classifying as noncurrent a short-term obligation that the borrower intends to refinance on a long-term basis using a financing agreement (see Example 6). Interest payments required on outstanding principal are due on a monthly basis. Amounts borrowed under the revolver are used to supplement working capital due to seasonal fluctuations. There are also standard loan covenants, such as being current on payments. Borrower was not in violation of any of these covenants on December 31, 20X0.

At December 31, 20X0: (a) the outstanding principle borrowed on the revolver is \$20 million; (b) the amount of eligible accounts receivable is \$14 million; and (c) the amount of finished goods inventory is \$16 million. Borrower expects that its lowest borrowing base occurs in conjunction with its December 31<sup>st</sup> balance sheet and does not expect its borrowing base as of December 31, 20X1 to fall below the borrowing base as of December 31, 20X0. Borrower is able to support and explain these expectations. How should the outstanding principle borrowed on the revolver be classified in Borrower's December 31, 20X0 balance sheet?

**Analysis:** Borrower must determine its borrowing base as of December 31, 20X0. The two components of the borrowing base at December 31, 20X0 are: (a) 75% of eligible accounts receivable, which is \$10.5 million (\$14 million x 75%); and (b) the lesser of 50% of finished goods inventory, which is \$8 million (\$16 million x 50%), and \$7 million. As such, Borrower's borrowing base at December 31, 20X0 is \$17.5 million (\$10.5 million + \$7 million). The

amount borrowed under the revolver as of the balance-sheet date is in excess of the borrowing base. Because of this, current classification is required for the \$2.5 million by which the amount borrowed under the revolver (\$20 million) exceeds the borrowing base at the balance-sheet date (\$17.5 million). Noncurrent classification is required for the remaining amount borrowed under the revolver (\$17.5 million) because Borrower does not expect its borrowing base to fall below \$17.5 million during 20X1 and because Borrower is effectively not otherwise required to make payments on that principle amount until August 31, 20X3 given that the revolving credit agreement meets the conditions included in Section 470-10-45-14b of the *Codification*.

## 8. Revolving Credit Agreement with Substantial Fluctuations in Borrowing Base

**Facts:** Borrower entered into a revolving credit agreement on September 1, 20X0. The revolver has a three-year term and the maximum that can be borrowed under the revolver is the lesser of: (a) \$25 million and (b) the total of (i) 75% of the eligible accounts receivable balance and (ii) 50% of finished goods inventory, capped at \$7 million. Amounts borrowed in excess of the maximum borrowing base at any quarterly balance-sheet date are due within 30 days of that date. Otherwise, the revolving credit agreement permits, over the term of the loan, a series of renewals or extensions that individually are for periods of less than one year (e.g., 90 days). As such, the short-term obligation is being refinanced with other short-term obligations until the end of the revolving credit agreement's term. The revolving credit agreement meets the conditions included in Section 470-10-45-14b of the *Codification* for classifying as noncurrent a short-term obligation that the borrower intends to refinance on a long-term basis using a financing agreement (see Example 6). Interest payments required on outstanding principal are due on a monthly basis. Amounts borrowed under the revolver are used to supplement working capital due to seasonal fluctuations. There are also standard loan covenants, such as being current on payments. Borrower was not in violation of any of these covenants on December 31, 20X0.

At December 31, 20X0, the outstanding principle borrowed on the revolver is \$20 million. Information relevant to the borrowing base at December 31, 20X0 (actual) and each of the quarters within 20X1 (estimated) are presented in the table that follows:

	(in millions)				
	12/31/X0	3/31/X1	6/30/X1	9/30/X1	12/31/X1
Amount of eligible accounts receivable	\$19	\$16	\$10	\$18	\$20
Amount of finished goods inventory	\$18	\$15	\$12	\$17	\$19
Borrowing base	\$21.25	\$19	\$13.5	\$20.5	\$22

Borrower is able to objectively support and explain the estimates for 20X1.

How should the outstanding principle borrowed on the revolver be classified in Borrower's December 31, 20X0 balance sheet?

**Analysis:** At December 31, 20X0, the amount borrowed under the revolver is not in excess of the borrowing base as of that date. However, the amount borrowed under the revolver as of December 31, 20X0 is in excess of the lowest expected borrowing base during 20X1 (June 30, 20X1). As such, current classification is required for the \$6.5 million by which the amount borrowed under the revolver at December 31, 20X0 (\$20 million) exceeds the lowest expected borrowing base to occur through 20X1 (\$13.5 million). Noncurrent classification is required for the remaining amount borrowed under the revolver (\$13.5 million) because Borrower does not expect its borrowing base to fall below \$13.5 million during 20X1 and because Borrower is effectively not otherwise required to make payments on that principle amount until August 31, 20X3 given that the revolving credit agreement meets the conditions included in Section 470-10-45-14b of the *Codification*.

Some might argue that because the amount borrowed under the revolver is not in excess of the borrowing base as of December 31, 20X0 and is not expected to be in excess of the expected borrowing base as of December 31, 20X1, that noncurrent classification of the entire amount borrowed under the revolver is appropriate at December 31, 20X0. However, to the extent it is reasonably expected that repayments will be required within the twelve months subsequent to the balance-sheet date due to a decline in the borrowing base, we believe a current maturity for the

reasonably expected debt repayment should be shown. This approach is based on the belief that this is consistent with the requirement that an assessment be made of the amount of debt that must be liquidated with current assets (i.e., the reduction in the borrowing base causes a repayment of the obligation).

## 9. Revolving Credit Agreement with Lock-Box Arrangement

**Facts:** Borrower entered into a revolving credit agreement on September 1, 20X0. The revolver has a three-year term and the maximum that can be borrowed under the revolver is \$50 million. Amounts borrowed under the revolver are used to supplement working capital due to seasonal fluctuations. The revolving credit agreement permits, over the term of the loan, a series of renewals or extensions that individually are for periods of less than one year (e.g., 90 days). As such, the short-term obligation is being refinanced with other short-term obligations until the end of the revolving credit agreement's term. The revolving credit agreement meets the conditions included in Section 470-10-45-14b of the *Codification* for classifying as noncurrent a short-term obligation that borrower intends to refinance on a long-term basis using a financing agreement (i.e., the revolver). In addition, Lender requires Borrower to have a lock-box arrangement whereby customers are required to submit all payments on invoices to the lock-box. Lender controls the lock-box and all collections are used to pay down the revolver. Borrower can request new advances under the revolver on a daily basis. The only other loan covenants involve standard items, which Borrower was not in violation of on December 31, 20X0. At December 31, 20X0, the outstanding principle borrowed on the revolver is \$12 million. How should the outstanding principle borrowed on the revolver be classified in Borrower's December 31, 20X0 balance sheet?

**Analysis:** The lock-box arrangement required by the revolving credit agreement is not maintained at Borrower's discretion as repayment of the amounts outstanding under the revolving credit agreement with lock-box proceeds happens automatically and contractually. In other words, cash received in the lock-box account in the ordinary course of business is used to repay amounts outstanding under the revolving credit agreement without another substantive event occurring. The existence of this type of lock-box arrangement indicates that borrowings under the revolver are reasonably expected to be repaid through the use of existing current assets. As such, absent the revolving credit agreement meeting the conditions included in Section 470-10-45-14b of the *Codification*, Borrower would classify the principle balance due on the revolver of \$12 million as current. However, because Borrower meets the conditions included in Section 470-10-45-14b of the *Codification* (i.e., the revolver effectively represents a form of long-term refinancing) the principle balance due on the revolver of \$12 million should be classified as noncurrent in Borrower's December 31, 20X0 balance sheet.

## 10. Revolving Credit Agreement with Traditional Lock-Box Arrangement and Subjective Acceleration Clauses

**Facts:** Borrower entered into a revolving credit agreement on September 1, 20X0. The revolver has a three-year term and the maximum that can be borrowed under the revolver is \$50 million. Amounts borrowed under the revolver are used to supplement working capital due to seasonal fluctuations. The revolving credit agreement permits, over the term of the loan, a series of renewals or extensions that individually are for periods of less than one year (e.g., 90 days). As such, the short-term obligation is being refinanced with other short-term obligations until the end of the revolving credit agreement's term. In addition, the revolving credit agreement includes the following provisions:

- Lender can require Borrower to pay all outstanding amounts within 30 days if a material adverse change occurs.
- Borrower must maintain a lock-box whereby customers are required to submit all payments on invoices to the lock-box. Lender controls the lock-box and all collections are used to pay down the revolver. Borrower can request new advances under the revolver on a daily basis.

The only other loan covenants involve standard items, which Borrower was not in violation of on December 31, 20X0. At December 31, 20X0, the outstanding principle borrowed on the revolver is \$12 million. How should the outstanding principle borrowed on the revolver be classified in Borrower's December 31, 20X0 balance sheet?

**Analysis:** The terms of the revolver require the conditions that are included in Section 470-10-45-14b of the *Codification* for classifying as noncurrent a short-term obligation that the borrower intends to refinance on a long-term basis to be evaluated to determine the classification of the balance due on the revolver. One of those conditions is that the agreement may only be cancelable within one year of the borrower's balance-sheet date by the lender if the borrower violates an *objectively* determinable or measurable provision of the agreement. The clause that permits Lender to accelerate payment because a material adverse change occurs is referred to as a *subjective* acceleration clause. Because the clause is subjective and because Lender controls the lock-box and all collections are used to pay down the revolver, the previously mentioned condition in Section 470-10-45-14b of the *Codification* has not been met. In other words, Lender is requiring Borrower to make payments on a daily (or short-term) basis when it also has the effective ability to unilaterally cancel the arrangement by exercising its rights under the subjective acceleration clause. The combination of these factors results in the principle balance due on the revolver of \$12 million being classified as current by Borrower in its December 31, 20X0 balance sheet.

Because Lender controls the lock-box, the likelihood of Lender exercising its rights under the subjective acceleration clause in 20X1 is not taken into consideration in evaluating the conditions in Section 470-10-45-14b of the *Codification*. The fact pattern in Example 11 includes a different type of lock-box arrangement that would require consideration of the likelihood of Lender exercising its rights under the subjective acceleration clause for purposes of determining the appropriate classification of the principle balance due on the revolver at December 31, 20X0.

## 11. Revolving Credit Agreement with Springing Lock-Box Arrangement and Subjective Acceleration Clauses

**Facts:** Borrower entered into a revolving credit agreement on September 1, 20X0. The revolver has a three-year term and the maximum that can be borrowed under the revolver is \$50 million. Amounts borrowed under the revolver are used to supplement working capital due to seasonal fluctuations. Lender requires Borrower to have a springing lock-box arrangement whereby customers are required to submit all payments on invoices to the lock-box, but Lender can only access the lock-box if: (a) Borrower fails to maintain satisfactory operations or (b) a material adverse change occurs. Borrower asserts that the likelihood of Lender exercising its rights under either of these clauses in 20X1 is remote. Borrower is able to objectively support and explain this assertion. Otherwise, the revolving credit agreement permits, over the term of the loan, a series of renewals or extensions that individually are for periods of less than one year (e.g., 90 days). As such, the short-term obligation is being refinanced with other short-term obligations until the end of the revolving credit agreement's term. The revolving credit agreement meets the conditions included in Section 470-10-45-14b of the *Codification* for classifying as noncurrent a short-term obligation that the borrower intends to refinance on a long-term basis using a financing agreement (see Example 6). The only other loan covenants involve standard items, which Borrower was not in violation of on December 31, 20X0. At December 31, 20X0, the outstanding principle borrowed on the revolver is \$12 million. How should the outstanding principle borrowed on the revolver be classified in Borrower's December 31, 20X0 balance sheet?

**Analysis:** Because the springing lock-box arrangement results in cash received in the lock-box account being used by Lender to repay the debt only if another event occurs (i.e., Lender exercises its right under one of the subjective acceleration clauses), the existence of the lock-box arrangement does not otherwise affect the classification of the amount borrowed under the revolving credit agreement. In contrast, the traditional lock-box arrangement in Example 10 is controlled by Lender from the outset and all collections are automatically used to pay down the revolver. As illustrated in Example 10, the existence of a traditional lock-box arrangement combined with a subjective acceleration clause affects the classification of the amount borrowed under the revolving credit agreement.

The clauses that permit Lender to access the lock-box either because Borrower fails to maintain satisfactory operations or because a material adverse change occurs are referred to as subjective acceleration clauses. Because the clauses are subjective, Borrower must consider the likelihood of Lender exercising its rights under either of the clauses during 20X1. Noncurrent classification is appropriate as of December 31, 20X0, because: (a) Borrower thinks it is remote that Lender will exercise its rights under either of the subjective acceleration clauses during 20X1 (and Borrower is able to support and explain this assertion) and (b) Borrower is effectively not otherwise required to make payments on the outstanding principle borrowed on the revolver until August 31, 20X3 given that the revolving credit

agreement meets the conditions included in Section 470-10-45-14b of the *Codification*. If Borrower thought it was more than remote that Lender would exercise its rights under one of the subjective acceleration clauses during 20X1, Borrower would need to consider whether current classification and (or) disclosure would be appropriate under the circumstances.

The fact pattern in Example 10 includes a traditional lock-box arrangement. As a result, the likelihood of Lender exercising its rights under the subjective acceleration clause in 20X1 is not considered. As illustrated in Example 10, the existence of a traditional lock-box arrangement combined with a subjective acceleration clause results in the current classification of the amount borrowed under the revolving credit agreement regardless of the likelihood of Lender exercising its rights under the subjective acceleration clause. In other words, this combination results in the failure to meet all of the conditions included in Section 470-10-45-14b of the *Codification*.

## 12. Due-on-Demand Debt

**Facts:** Borrower has a term loan agreement for \$10 million that commenced July 1, 20X0. Interest payments are due monthly. Regarding principle payments, the agreement includes a clause that states: "This loan is due on demand. If no demand is made, payments are due \$1 million each year on June 30<sup>th</sup>, with a final balance due on June 30, 20X5 of \$6 million." There are no loan covenants other than standard items, such as being current on payments. Borrower was not in violation of any of these covenants on December 31, 20X0. Borrower makes its first principle payment of \$1 million on June 30, 20X1. As of December 31, 20X1, Borrower believes it is unlikely that Lender will exercise its right under the due-on-demand clause during 20X2. How should the remaining principle balance for this term loan be classified in Borrower's December 31, 20X1 balance sheet?

**Analysis:** Borrower should classify the entire remaining principle balance (\$9 million) as current as of December 31, 20X1. Current classification is required because of the due-on-demand clause. Borrower's belief that it is unlikely that Lender will exercise its right under the due-on-demand clause during 20X2 should not result in noncurrent classification.

## 13. Callable Debt with Covenant Violation at Balance-Sheet Date and Grace Period

**Facts:** Borrower has a long-term loan that is callable by Lender if Borrower violates any debt covenant. Borrower must comply with these debt covenants on a quarterly basis. Borrower determines that it is in violation of a debt covenant at December 31, 20X0. The loan agreement provides a grace period during which Borrower may cure its violation of the debt covenant. The grace period extends to March 31, 20X1. Lender has not waived its right to demand payment at March 31, 20X1 if Borrower has not cured its violation. Borrower believes it is probable that it will be in compliance with the debt covenant by March 31, 20X1. Borrower is able to objectively support this assertion. Should the loan be classified as current or noncurrent in Borrower's December 31, 20X0 balance sheet?

**Analysis:** Noncurrent classification is required by Borrower as of December 31, 20X0 because it is probable that the debt covenant violation will be cured within the grace period (and Borrower is able to support and explain this assertion), which will negate Lender's ability to call the loan.

## 14. Long-Term Refinancing of Short-Term Obligation After Balance-Sheet Date

**Facts:** At December 31, 20X0, Borrower has a short-term obligation in the amount of \$8 million that is due by its terms on January 31, 20X1. On January 15, 20X1, Borrower enters into a long-term note payable in the amount of \$10 million of which \$8 million will be used to pay-off the short-term obligation at January 31, 20X1. The only loan covenants included in the long-term note payable are standard items. Borrower was not in violation of any of these covenants upon issuance of the long-term note payable or its financial statements. Should the short-term obligation be classified as current or noncurrent in Borrower's December 31, 20X0 balance sheet?

**Analysis:** Noncurrent classification is required by Borrower as of December 31, 20X0 because Borrower is able to demonstrate its ability to consummate long-term refinancing by issuing a long-term obligation after its balance-sheet

date but before issuance of its balance sheet. In addition, Borrower has not violated any of the covenants included in the long-term note payable when it issues its financial statements.

### 15. Long-Term Refinancing Obtained After Repayment of Short-Term Obligation

**Facts:** At December 31, 20X0, Borrower has a short-term obligation in the amount of \$8 million that is due by its terms on January 15, 20X1. Borrower pays off the short-term obligation on that date. On January 31, 20X1, Borrower enters into a long-term note payable in the amount of \$10 million. The purpose of this long-term note payable is to replenish Borrower's working capital given the reduction in working capital it experienced as a result of paying off the \$8 million short-term obligation. The only loan covenants included in the long-term note payable are standard items. Borrower was not in violation of any of these covenants upon issuance of the long-term note payable or its financial statements. Should the short-term obligation be classified as current or noncurrent in Borrower's December 31, 20X0 balance sheet?

**Analysis:** Current classification is required by Borrower as of December 31, 20X0 because Borrower repaid the short-term obligation prior to obtaining the long-term financing. The fact that the repayment and long-term financing both occurred after the balance-sheet date but before the financial statements were issued does not negate the fact that Borrower had to use its working capital to satisfy the short-term obligation before securing the refinancing.

### 16. Financing Agreement Obtained After Balance-Sheet Date to Repay Short-Term Obligation

**Facts:** At December 31, 20X0, Borrower has a short-term obligation in the amount of \$8 million that is due by its terms on June 30, 20X1. On January 15, 20X1, Borrower enters into a financing agreement in the amount of \$10 million of which \$8 million will be used to pay-off the short-term obligation at June 30, 20X1. Amounts borrowed under the financing agreement must be repaid by January 15, 20X3. Interest on amounts borrowed under the financing agreement must be paid on a monthly basis. The only covenants included in the financing agreement are standard items, with which compliance is objectively determinable or measurable. Borrower was not in violation of any of these covenants upon entering into the financing agreement or upon issuance of its financial statements. Amounts borrowed under the financing agreement are not otherwise callable by Lender. Other terms of the financing agreement (e.g., interest rate, payment dates, etc.) are readily determinable. During February and March of 20X1, publicly available information comes to light that draws into question whether Lender will be able to provide the financing needed by Borrower at June 30, 20X1 to pay off the short-term obligation due on that date. Should the short-term obligation be classified as current or noncurrent in Borrower's December 31, 20X0 balance sheet?

**Analysis:** Current classification is required by Borrower as of December 31, 20X0 because it is questionable whether Lender will have the economic ability to provide the financing required by Borrower to repay the short-term obligation on its due date. If not for the severe financial and regulatory difficulties experienced by Lender after entering into the financing agreement but before the issuance of Borrower's financial statements, Borrower would have classified the short-term obligation as noncurrent as of December 31, 20X0. This is supported by the financing agreement meeting the rest of the conditions included in Section 470-10-45-14b of the *Codification* for classifying as noncurrent a short-term obligation that the borrower intends to refinance on a long-term basis using a financing agreement. In other words, the financing agreement: (a) permits refinancing of the short-term obligation on a long-term basis; (b) includes readily determinable terms; (c) does not expire within one year of Borrower's balance-sheet date; (d) is only cancelable by Lender if Borrower violates an objectively determinable or measurable provision of the agreement and none of these provisions have been violated by Borrower prior to issuance of its financial statements; and (e) is not otherwise callable by Lender.

Given the current lending and regulatory environment, borrowers should be watchful of any indications of regulatory concerns facing their lenders and consider such concerns when determining the classification of their debt.

## D. Pre-Codification Source Literature Listing

Pre-Codification Source	Pre-Codification Source Title	Codification Paragraph(s)
ARB 43, Ch. 3A	Accounting Research Bulletin No. 43, <i>Restatement and Revision of Accounting Research Bulletins – Working Capital – Current Assets and Current Liabilities</i>	210-10-45-9 and 12 470-10-45-10 and 11 470-10-50-2
FAS 6	FASB Statement No. 6, <i>Classification of Short Term Obligations Expected to be Refinanced</i>	210-10-45-5 470-10-45-12A through 21 470-10-50-4 470-10-55-13 through 33
FAS 78	FASB Statement No. 78, <i>Classification of Obligations That Are Callable by the Creditor</i>	470-10-45-12
FIN 8	FASB Interpretation No. 8, <i>Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security</i>	470-10-45-15 470-10-55-34 through 36
FTB 79-3	FASB Technical Bulletin No. 79-3, <i>Subjective Acceleration Clauses in Long-Term Debt Agreements</i>	470-10-45-2 470-10-50-3
EITF 86-5	EITF Issue No. 86-5, "Classifying Demand Notes with Repayment Terms"	470-10-45-9 through 10
EITF 86-30	EITF Issue No. 86-30, "Classification of Obligations When a Violation Is Waived by the Creditor"	470-10-45-1 470-10-55-2 through 6
EITF 95-22	EITF Issue No. 95-22, "Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement"	470-10-45-3 through 6