FUNDAMENTALS OF DEBT CLASSIFICATION

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OVERVIEW

Many entities are required to prepare a classified balance sheet in which assets and liabilities are presented as current or noncurrent. Current liabilities include those liabilities that are expected to be paid (i.e., liquidated) within a relatively short period of time, usually 12 months (or the entity's operating cycle). However, seemingly straight-forward debt agreements sometimes include terms that can cause surprising classification issues. For example, a significant deterioration in economic conditions could result in cash flow problems or the impairment of assets on the balance sheet, thereby increasing the likelihood that a subjective acceleration clause will be exercised by a lender. This increased likelihood has repercussions on the borrower's classification of the underlying debt. Furthermore, when dealing with covenant violations, 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. This publication is designed to assist entities in determining the appropriate classification of debt.

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1 INTRODUCTION

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.

A few of the more common issues and factors to consider when determining the appropriate classification of debt include:

- *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?* If a borrower finds at some point during the term of the agreement that it is in violation of one or more debt covenants at the balance sheet date, it 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?* One common subjective acceleration clause is known as a "material adverse changes" clause. The assessment of the likelihood that such a clause will be exercised 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?* 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?* At times, borrowers may 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.

The relevant guidance is summarized in Chapter 2, with numerous examples illustrating application of the guidance included in Chapter 3. The table below summarizes the classification conclusions for certain scenarios and references the relevant section that discusses the topic in further detail. For the scenarios included below, assume the debt does not mature within one year unless covenant violations occur or otherwise stated.

Scenario	General Classification	Relevant Section
No debt covenant violation at balance sheet date	Noncurrent, regardless of whether debt covenant provisions are violated in the future	Section 2.3
Debt covenant violation at balance sheet date (or debt covenant violation avoided through modification before the balance sheet date)—no grace period, waiver obtained and • Covenant compliance is not required within 12 months from the balance sheet date • Covenant compliance is required within 12 months from the balance sheet date, and – It is probable that a future violation of a debt covenant will occur at compliance dates within the next 12 months – It is only reasonably possible or remote (not probable) that a future violation of a debt covenant will occur at compliance dates within the next 12 months	Noncurrent Current Noncurrent	Section 2.3
Debt covenant violation at balance sheet date—no grace period and no waiver obtained	Current	Section 2.3
Due-on-demand clauses	Current	Section 2.7
Callable debt due to the violation of a provision of the debt agreement at balance sheet date, and • Waiver obtained during grace period or lender otherwise loses the right to demand payment for more than 12 months from balance sheet date • Waiver not obtained during grace period and it is not probable that the borrower will cure the violated provision during the grace period • Waiver not obtained during grace period but it is probable that the borrower will cure the violated provision during the grace period	Noncurrent Current Noncurrent	Section 2.8
Short-term debt that is intended to be refinanced on a long-term basis in which: • Long-term obligation agreement is executed or equity securities are issued to replace the short-term debt after the balance sheet date, but before the balance sheet is issued or available to be issued	Noncurrent	Section 2.9

Scenario	General Classification	Relevant Section
• A long-term financing agreement that meets certain criteria is in the process of being entered into to replace the short-term debt before the balance sheet is issued or available to be issued	Noncurrent	
• Neither of the preceding bullet points are met	Current	

When applying the guidance discussed in Chapter 2, it is necessary to determine the timeframe used to designate liabilities as current or noncurrent. As discussed in Section 2.2, that timeframe is 12 months or, if longer, the entity's operating cycle. For purposes of simplicity, we only refer to the 12 months (or one year) timeframe in this paper. In addition, the guidance discussed in Chapter 2 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.

2 RELEVANT LITERATURE AND GENERAL CONCEPTS

2.1 Classified balance sheet

Relevant codification section: ASC 210-10-45-5

When a classified balance sheet is presented, a total of current liabilities must be shown.

2.2 Current liabilities

Relevant codification sections: ASC 210-10-45-9 and 45-12

Current liabilities include those liabilities that are expected to be paid (i.e., liquidated) within a relatively short period of time, usually 12 months or the entity's operating cycle. Examples of other liabilities that fall within this classification include short-term debts undertaken to acquire capital assets, serial maturities of long-term debt and sinking fund expenditures expected to occur within one year.

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. In other words, designating a liability as "current" means that the extinguishment of that liability is reasonably expected to require the use of existing current assets or incurring other current liabilities.

2.3 Violation of debt covenants

Relevant codification sections: ASC 470-10-45-1 and 45-11; ASC 470-10-55-2 through 55-6

When a violation of a debt covenant gives the lender the right to call the debt as of the balance sheet date, such violation will typically result in the classification of the debt as current by the borrower, unless the lender waives its right to call the debt for a period of greater than one year.

In situations where the debt requires compliance with covenants within 12 months following the balance sheet date, and the future covenant requirements are retained by the lender, the classification depends on a combination of factors. If at the balance sheet date the borrower was in compliance with the original covenant requirements (i.e., no waiver or modification was required), the debt would be classified as long-term without consideration of whether it would meet the future covenants or not. If, however, the covenant violation occurred at the balance sheet date, or would have occurred without the lender and borrower agreeing to modify the loan, and it is probable that the borrower will not be able to comply with the covenant at compliance dates that occur within the next 12 months, the debt would be classified as current unless all current and probable future violations of the covenant are waived for a period of greater

than one year. Such situations also assume that the debt does not contain a grace period during which the borrower is allowed to cure the violation (See Section 2.8).

Examples of debt covenants include maintenance of a minimum current ratio, maximum debt to equity ratio, minimum level of stockholders' equity or minimum fixed charge coverage ratio; prohibition from incurring or maintaining indebtedness in excess of a specified amount; prohibition from annual capital expenditures above a specified amount; and maintenance of a minimum amount of earnings before interest, taxes, depreciation and amortization for quarterly or annual periods.

If application of this guidance results in noncurrent classification, disclosure of probable future noncompliance with debt covenants may still be required.

RSM COMMENTARY: 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 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 waiver that has been approved by a loan officer with appropriate authority to grant the waiver and negotiate the terms of the waiver is considered substantive.

In considering whether a potential future violation would result in noncurrent classification, the threshold for current classification is whether a future violation is probable. If a future violation is only reasonably possible or remote, the debt should be classified as noncurrent.

Judgment must be exercised in assessing the probability of a covenant violation in the future. There must be objective support for the conclusion reached. In addition, the borrower should consider whether the conclusion reached is consistent with its historical ability to comply with covenants and 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 it being unlikely that the lender will enforce the covenant or it being the lender's historical practice to not enforce covenants.

2.4 Subjective acceleration clause (SAC)

Relevant codification sections: ASC 470-10-45-2; ASC 470-10-50-3

When a debt agreement includes an SAC, 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 an SAC 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 an SAC 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 SAC. 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 or disclosure is appropriate under the circumstances.

RSM COMMENTARY: Judgment must be exercised in assessing the likelihood of the lender exercising its rights under an SAC. There must be objective support for the conclusion reached. In addition, the borrower should consider whether the conclusion reached is consistent with the lender's past practice with respect to exercising its rights under SACs, whether the borrower has been able to accurately predict the likelihood of a lender exercising its rights under SACs in the past and how the current conditions might affect the borrower's ability to assess the likelihood of the lender exercising its rights under an SAC (i.e., based on current conditions, if the borrower's ability to make the assessment in the past is truly indicative of its ability to make the assessment today).

2.5 Revolving credit agreements

Relevant codification sections: ASC 470-10-45-3 through 45-6

The classification of a revolving credit agreement as current or noncurrent depends on a number of factors. Defaulting to a current classification is generally not appropriate unless supported by the facts and circumstances. Consider the following factors:

- 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)?
  - If so, classify the borrowings as noncurrent. The effects of lock-box arrangements and SACs are assessed separately and may result in current classification (see bullet points that follow).
- Are 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 470-10-45-14(b) (i.e., those criteria used to classify a short-term obligation that the borrower intends to refinance on a long-term basis as noncurrent). 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.
- If a revolving credit agreement requires that each draw be supported or documented by a note, is it necessary for all borrowings under the agreement to be accompanied by individual notes with maturity dates that differ from the overall maturity date of the revolving credit agreement?
  - If so, we believe each borrowing should be classified according to the maturity date of the individual note, not the maturity date of the revolving credit agreement. If an individual note has a maturity date of more than one year from the balance sheet date, then the borrowing under that note should be classified as noncurrent.
- 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 470-10-45-14(b) (i.e., those criteria used to classify a short-term obligation that the borrower intends to refinance on a long-term basis as noncurrent). If the revolving credit agreement includes an SAC, it will fail the first of the criteria in ASC 470-10-45-14(b) regardless of the likelihood of the SAC 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 an SAC that is triggered by the lender)?
  - If so, the existence of the lock-box arrangement does not otherwise affect the classification of the borrowings; however, consideration should be given to any SACs (see Section 2.4).

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 or an SAC.

Lock-Box Arrangement	SAC	Current or Noncurrent?
No	No	Noncurrent
No	Yes	Depends on whether the possibility that the lender will exercise its rights under the clause is remote
Traditional	No	Current, unless the criteria in ASC 470-10-45-14(b) are met, then classify as noncurrent
Traditional	Yes	Current
Springing	Yes	Depends on whether the possibility that the lender will exercise its rights under the clause is remote

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). A springing lock-box arrangement is one in which the cash received in the lock-box account is only used to repay the borrowings if there is an SAC that is triggered by the lender.

2.6 Increasing-rate debt

Relevant codification sections: ASC 470-10-35-1; ASC 470-10-45-7 through 45-8

When a loan agreement includes provisions that could cause the term to be extended at the option of the borrower at each maturity date until final maturity, it will typically also include a provision that will increase the interest rate by a specified amount at the time of each extension. This is referred to as increasing-rate debt.

The classification of increasing-rate debt as current or noncurrent should be based on the borrower's anticipated source of repayment, which may not be consistent with the timeframe used to determine periodic interest expense. In other words, classification is based on the same general guidance in ASC 470-10 that applies to all other debt instruments. If the entity does not expect to extend the debt's maturity date past 12 months, the loan should be classified as current. If the borrower has the ability and intent to

extend the debt's maturity date by exercising the extension option, the debt should be classified as noncurrent. If the borrower intends to refinance the debt, the guidance in Section 2.9 should be applied.

2.7 Due-on-demand loan agreement

Relevant codification sections: ASC 470-10-45-9 through 45-10

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 an SAC 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.

2.8 Callable obligation

Relevant codification sections: ASC 470-10-45-11 through 45-12; ASC 470-10-50-2

An obligation may be callable at the balance sheet date because the borrower violated a provision of the underlying debt agreement, or it may become callable subsequent to the balance sheet date if that violation is not cured during a specified grace period. The borrower classifies these callable obligations as current unless 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 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, all violations matter from a classification perspective. There is different classification guidance for obligations that are "due on demand" and those that are "callable" because a "callable" obligation, as this terminology is used in ASC 470-10, only becomes due on demand in certain circumstances (e.g., the borrower violated a provision of the underlying debt agreement). Consideration should be given to Section 2.7 for obligations that are unconditionally callable, as they are in substance due on demand.

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.

RSM COMMENTARY: 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 whether the conclusion reached is consistent with its historical ability to cure violations during the grace period and whether the borrower has historically been able to accurately predict its ability to cure violations during the grace period.

2.9 Effects of expected long-term refinancing on classification of short-term obligations

Relevant codification sections: ASC 470-10-45-12A through 45-21; ASC 470-10-50-4; ASC 470-10-55-1; ASC 470-10-55-13 through 55-36

A borrower may intend to refinance a short-term obligation on a long-term basis. To accomplish this, the borrower could replace the short-term obligation with a long-term obligation; modify the short-term obligation to extend the maturity date to a period more than one year from the borrower's balance sheet date; replace the short-term obligation with equity securities; or 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]) should be classified as noncurrent if the borrower is able to demonstrate its ability to consummate the long-term refinancing by either:

- Completing the issuance of 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 as noted in ASC 470-10-45-14(a)
- Entering into a financing agreement before the borrower's balance sheet is issued or available to be issued and all of the following criteria are met:
  - The agreement permits refinancing of the short-term obligation on a long-term basis and does not include provisions, either contractual or legal, that would restrict the borrower's ability to access any of the funds
  - 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 investor) 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)
  - The party that would provide the financing has the economic ability to provide the financing (i.e., the lender has the financial wherewithal 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; it should be classified as a long-term obligation.

RSM COMMENTARY: While the guidance from ASC 470-10-45 specifically notes that refinancing a short-term obligation involves replacing it with a long-term obligation, we believe the guidance would also apply to the modification of a short-term obligation (rather than a replacement) that extends the maturity date of that obligation. As a result, if a short-term obligation is modified to extend the maturity date to a period more than one year from the borrower's balance sheet date and the modification occurs after year-end, but before the financial statements are issued or available to be issued, the debt balance should be classified as noncurrent as of the balance sheet date.

RSM COMMENTARY: Certain debt instruments permit or require the borrower to pay interest in the form of paid-in-kind (PIK) notes with the same terms as the original debt, rather than cash. If the borrower intends or is required to pay the interest with additional notes, we believe the balance sheet classification of the accrued interest payable should be assessed under the preceding guidance.

2.9.1 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 or a determination that it is probable that the violation will be cured during the grace period, 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 maintaining a certain level of working capital, restrictions on entering into any lease agreements with rentals in excess of a certain amount, restrictions on acquiring treasury stock without the permission of the party that would provide the financing and 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. As stated in ASC 470-10-45-14(b)(1), “financing agreements cancelable for violation of a provision that can be evaluated differently by the parties to the agreement (such as a material adverse change or failure to maintain satisfactory operations) do not comply with this condition.” As a result, in an arrangement that includes an SAC, even if the borrower believes the probability of the lender exercising the SAC is remote, this criterion is still not met. The likelihood of the SAC being exercised is not considered in the analysis, unlike the discussion in Section 2.4.

2.9.2 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.

2.9.3 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.

2.9.4 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 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 to 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 by 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.

RSM COMMENTARY: Exercise judgement when 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.

2.9.5 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. It would not be appropriate to classify the short-term obligation as noncurrent if the borrower does not intend to use the "in-place" financing agreement. In assessing the borrower's intent to use the in-place financing agreement 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.

2.9.6 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.

2.9.7 Parent company financing

Subsidiaries may obtain additional financing from their parent company in the form of long-term debt or additional equity. When a subsidiary is issuing stand-alone financial statements, it may receive a financing commitment from its parent company as evidence of its intent and ability to refinance its short-term debt on a long-term basis. We believe the parent's commitment must meet the criteria discussed in Section 2.9 to be classified as noncurrent. Due to the parent and subsidiary being related parties, careful consideration should be given to the evidence supporting this financing commitment.

2.9.8 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.

3 EXAMPLES

For purposes of the examples included herein, assume that Borrower presents a classified balance sheet on an annual basis as of December 31 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 March 31 following the balance sheet date.

Example 3-1: 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 balance sheet as of December 31, 20X0?

Analysis: In accordance with ASC 470-10-45-1, noncurrent classification is required by Borrower as of December 31, 20X0, because it is not probable that Borrower will fail to comply with the covenants at each compliance date that occurs within the waiver period, which exceeds 12 months.

Example 3-2: 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 balance sheet as of December 31, 20X0?

Analysis: In accordance with ASC 470-10-45-1, 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.

Example 3-3: 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 on future compliance dates. It is probable that Borrower will fail to comply with the covenant by the next compliance date (March 31, 20X1), but it is not probable that Borrower will fail 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 balance sheet as of December 31, 20X0?

Analysis: In accordance with ASC 470-10-45-1, 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.

Example 3-4: 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 probable that the debt covenants will not be met at the subsequent quarterly compliance dates. Should the long-term loan be classified as current or noncurrent in Borrower's balance sheet as of December 31, 20X0?

Analysis: In accordance with ASC 470-10-45-1, current classification is required by Borrower as of December 31, 20X0, because a debt covenant violation would have occurred absent the loan modification 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.

Example 3-5: Subjective acceleration clauses

Facts: Borrower has a long-term loan that allows Lender to accelerate payment if Borrower fails to maintain satisfactory operations or 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 determines 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. 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 balance sheet as of December 31, 20X0?

Analysis: In accordance with ASC 470-10-45-2, 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 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 the likelihood that Lender would exercise its rights under one of these clauses during 20X1 was more than remote, Borrower would need to consider whether current classification and (or) disclosure would be appropriate under the circumstances.

Example 3-6: 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 principal borrowed on the revolver is $12 million. How should the outstanding principal borrowed on the revolver be classified in Borrower's balance sheet as of December 31, 20X0?

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 ASC 470-10-45-14(b) for classifying a short-term obligation that the borrower intends to refinance on a long-term basis using a financing agreement as noncurrent. For purposes of this example, assume that Borrower meets those conditions. As such, Borrower should classify the principal 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 principal 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 principal balance on the revolver because the conditions included in ASC 470-10-45-14(b) are met.

Example 3-7: 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 or (b) the total of 75% of the eligible accounts receivable balance and 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 ASC 470-10-45-14(b) for classifying a short-term obligation that the borrower intends to refinance on a long-term basis using a financing agreement as noncurrent (see Example 3-6). 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 principal borrowed on the revolver is $20 million, the amount of eligible accounts receivable is $14 million and the amount of finished goods inventory is $16 million. Borrower expects that its lowest borrowing base occurs in conjunction with its December 31 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 principal borrowed on the revolver be classified in Borrower's balance sheet as of December 31, 20X0?

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 principal amount until August 31, 20X3, given that the revolving credit agreement meets the conditions included in ASC 470-10-45-14(b).

Example 3-8: 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 75% of the eligible accounts receivable balance and 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 ASC 470-10-45-14(b) for classifying a short-term obligation that the borrower intends to refinance on a long-term basis using a financing agreement as noncurrent (see

Example 3-6). 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 principal 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:

	Amount (in millions)				
	12/31/X0	3/31/X1	6/30/X1	9/30/X1	12/31/X1
Eligible accounts receivable	$19	$16	$10	$18	$20
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 principal borrowed on the revolver be classified in Borrower's balance sheet as of December 31, 20X0?

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 principal amount until August 31, 20X3, given that the revolving credit agreement meets the conditions included in ASC 470-10-45-14(b).

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 if the reduction in the borrowing base causes a repayment of the obligation.

Example 3-9: 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 ASC 470-10-45-14(b) for classifying a short-term obligation that Borrower intends to refinance on a long-term basis using a financing agreement

(i.e., the revolver) as noncurrent. 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 account. Lender controls the lock-box account 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 principal borrowed on the revolver is $12 million. How should the outstanding principal borrowed on the revolver be classified in Borrower's balance sheet as of December 31, 20X0?

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 ASC 470-10-45-14(b), Borrower would classify the principal balance due on the revolver of $12 million as current. However, because Borrower meets the conditions included in ASC 470-10-45-14(b) (i.e., the revolver effectively represents a form of long-term refinancing), the principal balance due on the revolver of $12 million should be classified as noncurrent in Borrower's December 31, 20X0, balance sheet.

Example 3-10: 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 account whereby customers are required to submit all payments on invoices to the lock-box account. Lender controls the lock-box account 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 principal borrowed on the revolver is $12 million. How should the outstanding principal borrowed on the revolver be classified in Borrower's balance sheet as of December 31, 20X0?

Analysis: The terms of the revolver require evaluation of the conditions that are included in ASC 470-10-45-14(b) for classifying a short-term obligation that the borrower intends to refinance on a long-term basis as noncurrent 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 an SAC. Because the clause is subjective and because Lender controls the lock-box account and all collections are used to pay down the revolver, the previously mentioned condition in ASC 470-10-45-14(b) 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 SAC. The combination of these factors results in the principal balance due on the revolver of $12 million being classified as current by Borrower in its balance sheet as of December 31, 20X0.

Because Lender controls the lock-box account, the likelihood of Lender exercising its rights under the SAC in 20X1 is not taken into consideration in evaluating the conditions in ASC 470-10-45-14(b). The fact pattern in Example 3-11 includes a different type of lock-box arrangement that would require consideration of the likelihood of Lender exercising its rights under the SAC for purposes of determining the appropriate classification of the principal balance due on the revolver at December 31, 20X0.

Example 3-11: 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 account, but Lender can only access the lock-box account if Borrower fails to maintain satisfactory operations or 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 ASC 470-10-45-14(b) for classifying a short-term obligation that the borrower intends to refinance on a long-term basis using a financing agreement as noncurrent (see Example 3-6).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 principal borrowed on the revolver is $12 million. How should the outstanding principal borrowed on the revolver be classified in Borrower's balance sheet as of December 31, 20X0?

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 SACs), 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 3-10 is controlled by Lender from the outset and all collections are automatically used to pay down the revolver. As illustrated in Example 3-10, the existence of a traditional lock-box arrangement combined with an SAC affects the classification of the amount borrowed under the revolving credit agreement.

The clauses that permit Lender to access the lock-box account either because Borrower fails to maintain satisfactory operations or because a material adverse change occurs are referred to as SACs. 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 Borrower thinks it is remote that Lender will exercise its rights under either of the SACs during 20X1 (and Borrower is able to support and explain this assertion) and Borrower is effectively not otherwise required to make payments on the outstanding principal borrowed on the revolver until August 31, 20X3, given that the revolving credit agreement meets the conditions included in ASC 470-10-45-14(b). If Borrower thought the likelihood that Lender would exercise its rights under one of the SACs during 20X1 was more than remote, Borrower would need to consider whether current classification and (or) disclosure would be appropriate under the circumstances.

Example 3-12: 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 principal payments, the agreement includes a clause that states: "This loan is due on demand. If no demand is made, payments of $1 million are due each year on June 30, 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 principal 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 principal balance for this term loan be classified in Borrower's balance sheet as of December 31, 20X1?

Analysis: In accordance with ASC 470-10-45-10, borrower should classify the entire remaining principal 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.

Example 3-13: Callable debt as a result of a change in control

Facts: Borrower has a long-term loan that is callable by Lender if there is a change in control of Borrower. The loan agreement provides a period of 90 days subsequent to the change in control during which Lender can demand repayment. If Lender does not request repayment before the expiration of the 90-day period, Lender loses their right to call the debt.

On November 11, 20X1, Borrower is acquired and the debt becomes callable by Lender as of that date through December 31, 20X1. However, as of the financial statement issuance date of February 15, 20X2, Lender had not called the debt and the call right expired unexercised. Should the loan be classified as current or noncurrent in Borrower's balance sheet as of December 31, 20X1?

Analysis: Because Borrower concluded that Lender's right to call the debt as a result of the change in control has expired unexercised on or before the date the 20X1 financial statements are issued (or available to be issued), Borrower would classify the debt as noncurrent on its balance sheet as of December 31, 20X1, in accordance with ASC 470-10-45-11.

Example 3-14: 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 balance sheet as of December 31, 20X0?

Analysis: In accordance with ASC 470-10-45-11, 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.

Example 3-15: 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 repay 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 balance sheet as of December 31, 20X0?

Analysis: In accordance with ASC 470-10-45-14(a), 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.

Example 3-16: 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 repays 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 repaying 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 balance sheet as of December 31, 20X0?

Analysis: In accordance with ASC 470-10-45-14(a), 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.

Example 3-17: 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 repay 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) 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 repay the short-term obligation due on that date. Should the short-term obligation be classified as current or noncurrent in Borrower's balance sheet as of December 31, 20X0?

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 ASC 470-10-45-14(b) for classifying a short-term obligation that the borrower intends to refinance on a long-term basis using a financing agreement as noncurrent. In other words, the financing agreement permits refinancing of the short-term obligation on a long-term basis, includes readily-determinable terms, does not expire within one year of Borrower's balance sheet date, 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 is not otherwise callable by Lender.

Example 3-18: Modification of short-term obligation after balance sheet date to extend maturity 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 March 31, 20X1. On January 31, 20X1, prior to issuing its financial statements, Borrower modifies the note payable and, as part of the modification, the maturity date is extended to June 30, 20X3. The only loan covenants included in the note payable before and after the modification are standard items. Borrower was not in violation of any of these covenants at year-end, upon modification of the note payable or upon issuance of its financial statements. Should the short-term obligation be classified as current or noncurrent in Borrower's balance sheet as of December 31, 20X0?

Analysis: We believe 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 modifying the note payable after its balance sheet date, but before issuance of its financial statements, to extend the maturity date to a period more than one year from the borrower's balance sheet date. In addition, Borrower has not violated any of the covenants included in the note payable when it issues its financial statements.

Example 3-19: Classification of accrued interest settleable in PIK notes

Facts: At December 31, 20X0, Borrower has a long-term obligation in the amount of $8 million that is due by its terms on December 31, 20X3. The debt accrues semiannual interest which Borrower may choose to pay in cash or additional PIK notes. Borrower intends to pay the interest in the form of additional PIK notes with the same maturity dates as the original note. Should the accrued interest be classified as current or noncurrent in Borrower's balance sheet as of December 31, 20X0?

Analysis: We believe the Borrower should classify the accrued interest as noncurrent as of December 31, 20X0, because Borrower meets all of the conditions in Section 2.9:

- The original agreement permits refinancing the short-term liability (accrued interest) 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 to permit Borrower to satisfy interest with long-term PIK notes is not cancellable by the lender
- There is no violation of any financing provisions, as of the balance sheet date or in the period prior to issuance of the financial statements, that would cause the original or additional PIK loans to be callable or prevent Borrower from electing to pay the interest in the form of PIK notes
- Lender has the economic ability to honor the terms of the agreement

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