Statement of Financial Accounting Standards No. 78

FAS78 Status Page
FAS78 Summary

Classification of Obligations That Are Callable by the Creditor

an amendment of ARB No. 43, Chapter 3A

December 1983

Financial Accounting Standards Board
of the Financial Accounting Foundation
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CONTENTS

Paragraph Numbers

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FAS 78 Summary

This Statement amends ARB No. 43, Chapter 3A, "Current Assets and Current Liabilities," to specify the balance sheet classification of obligations that, by their terms, are or will be due on demand within one year (or operating cycle, if longer) from the balance sheet date. It also specifies the classification of long-term obligations that are or will be callable by the creditor either because the debtor's violation of a provision of the debt agreement at the balance sheet date makes the obligation callable or because the violation, if not cured within a specified grace period, will make the obligation callable. Such callable obligations are to be classified as current liabilities unless one of the following conditions is met:

a. The creditor has waived or subsequently lost the right to demand repayment for more than one year (or operating cycle, if longer) from the balance sheet date.
b. For long-term obligations containing a grace period within which the debtor may cure the violation, it is probable that the violation will be cured within that period, thus preventing the obligation from becoming callable.

Short-term obligations expected to be refinanced on a long-term basis, including those callable obligations discussed herein, continue to be classified in accordance with FASB Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced.* This Statement is effective for financial statements for fiscal years beginning after December 15, 1983 and for interim periods within those fiscal years.

INTRODUCTION

1. The FASB has been requested to clarify how obligations that are callable [1] by the creditor should be presented by the debtor in a balance sheet in which liabilities are classified as current

or noncurrent. Specifically, the issue is whether an obligation should be classified as a current liability if the debtor is in violation of a provision [2] of a long-term debt agreement at the balance sheet date and (a) the violation makes the obligation callable by the creditor within one year from the balance sheet date or (b) the violation, if not cured within a specified grace period, will make the obligation callable within one year from the balance sheet date (or operating cycle in both cases, if longer). In considering that issue, the Board also decided to clarify whether an obligation should be classified as a current liability if the obligation, by its terms, is or will be due on demand within that period.

2. Some obligations, by their terms, are due on demand; that is, they are callable by the creditor. Other obligations have scheduled future maturities but nevertheless are callable if the debtor is in violation of certain provisions of the related debt agreement or if the creditor has the right to accelerate those maturities for other reasons. Some obligations with scheduled future maturities will become callable if an existing violation of a provision of the debt agreement is not cured within a specified grace period.

3. Paragraph 7 of ARB No. 43, Chapter 3A, "Current Assets and Current Liabilities," discusses obligations that should be considered current liabilities and states:

> The term *current liabilities* is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities. . .

FASB Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced,* amends ARB 43, Chapter 3A to require short-term obligations arising from transactions in the normal course of business that are due in customary terms (such as trade payables, advance collections, and accrued expenses) to be classified as current liabilities in all instances. Other short-term obligations are excluded from current liabilities under that Statement only if the enterprise intends to refinance the obligation on a long-term basis and such intent is supported by an ability to consummate the refinancing, demonstrated by either a financing agreement or the post-balance-sheet-date issuance of a long-term obligation or equity securities. Neither ARB 43, Chapter 3A nor Statement 6, however, discusses how obligations that are callable by the creditor should be presented in a classified balance sheet. As a result of differing views on such presentation, the same types of obligations have been classified differently by various entities in similar circumstances.

APPLICABILITY AND SCOPE

4. This Statement applies to obligations reported in classified balance sheets and to disclosures made about maturities of obligations reported in both classified and unclassified

balance sheets. It does not modify Statement 6 or FASB Statement No. 47, *Disclosure of Long-Term Obligations.*

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment to ARB No. 43, Chapter 3A

5. The following sentences and footnotes are added to the end of paragraph 7 of ARB 43, Chapter 3A:

> The current liability classification is also intended to include obligations that, by their terms, are due on demand or will be due on demand within one year (or operating cycle, if longer) from the balance sheet date, even though liquidation may not be expected within that period. It is also intended to include long-term obligations that are or will be callable by the creditor either because the debtor's violation of a provision of the debt agreement at the balance sheet date makes the obligation callable or because the violation, if not cured within a specified grace period, will make the obligation callable. Accordingly, such callable obligations shall be classified as current liabilities unless one of the following conditions is met:
>
> a. The creditor has waived* or subsequently lost † the right to demand repayment for more than one year (or operating cycle, if longer) from the balance sheet date.
> b. For long-term obligations containing a grace period within which the debtor may cure the violation, it is probable‡ that the violation will be cured within that period, thus preventing the obligation from becoming callable.
>
> If an obligation under (b) above is classified as a long-term liability (or, in the case of an unclassified balance sheet, is included as a long-term liability in the disclosure of debt maturities), the circumstances shall be disclosed. Short-term obligations that are expected to be refinanced on a long-term basis, including those callable obligations discussed herein, shall be classified in accordance with FASB Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced.*
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> ---
>
> *If the obligation is callable because of violations of certain provisions of the debt agreement, the creditor needs to waive its right with regard only to those violations.
>
> †For example, the debtor has cured the violation after the balance sheet date and the obligation is not callable at the time the financial statements are issued.
>
> ‡Probable is defined in FASB Statement No. 5, Accounting for Contingencies, as "likely to occur" and is used in the same sense in this paragraph.

Effective Date and Transition

6. This Statement shall be effective for financial statements for fiscal years beginning after December 15, 1983 and for interim accounting periods within those fiscal years. Earlier application is encouraged in financial statements that have not previously been issued. This Statement may be, but is not required to be, applied retroactively to previously issued financial statements.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of four members of the Financial Accounting Standards Board. Messrs. Block, Brown, and Walters dissented.

Messrs. Block, Brown, and Walters dissent from this Statement because they see no demonstrated need for it and because it is a further step to supplant judgment in financial reporting with arbitrary rules.

The concept of current liabilities, which was adopted over 35 years ago, comprises obligations whose liquidation is *reasonably expected* to consume existing current assets within a certain time span—usually one year. The reasonable expectation notion implies that judgment should be applied to known facts and circumstances to assess the probable timing of liquidation. Statement 6 pointed out that reasonable expectations in the cases it considered must be supported by intent and evidence of an ability to refinance; but the Board then specifically rejected a strict maturity date (or worst case) approach "because . . . [it] is not necessarily indicative of the point in time at which that obligation will require the use of the enterprise's funds" and because "that approach would also result in a major change in the concept of current liabilities described in . . . *ARB No. 43* . . ." (Statement 6, paragraph 23). The Board should not now change that concept of current liabilities unless it is able to demonstrate clearly how information that will result from the new concept is expected to be more useful.

This standard is a major change in the concept of current liabilities. It is based on a notion that obligations should be classified as current when they are legally callable within one year, whether or not they are likely to be called. This is a worst-case notion, not a reasonable-expectation notion. While the two notions may often give the same answer, they will not in all cases. It is asserted that this amendment will improve comparability. It will, in fact, cause situations to appear the same even when underlying facts and circumstances are sufficiently different to justify different reasonable expectations. This is not comparability; it is substituting an arbitrary rule for judgment.

Not only will the amendment classify essentially different situations similarly but it will also cause essentially similar situations to be classified differently. For example, the dissenters do not perceive any substantive difference between a demand loan and a loan with a subjective acceleration clause. In each case there must be cause for repayment to be demanded and the lender must not be unreasonable in demanding repayment. Thus, essentially similar liabilities could be classified as current under this Statement and as noncurrent under FASB Technical Bulletin No. 79-3, *Subjective Acceleration Clauses in Long-Term Debt Agreements.*

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
Victor H. Brown
John W. March
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

7. An Exposure Draft of a proposed Statement, *Classification of Obligations That Are Callable by the Creditor,* was issued on July 30, 1982. The Board received 85 comment letters in response to the Exposure Draft. This appendix discusses the significant comments received during the exposure period and the factors deemed significant by the Board in reaching the conclusions in this Statement, including alternatives considered and reasons for accepting some and rejecting others. Individual Board members gave greater weight to some factors than to others. The Board concluded that it could reach an informed decision on the basis of existing information without a public hearing and that the effective date and transition specified in paragraph 6 are advisable in the circumstances.

8. Some have questioned the value of the current asset and current liability classifications which they believe are, at best, crude and superficial indicators of liquidity. Some Board members share those concerns; nonetheless, they recognize that those classifications and the resulting terms and ratios are widely used by creditors and are often incorporated in financing agreements. In addition, they believe that any reconsideration of the broad issue of balance sheet classification should be addressed in the Board's major agenda project on the reporting of income, cash flows, and financial position. Accordingly, until other measures of liquidity or funds flow are determined to be preferable, those Board members agreed to clarify the classification of obligations under the present system by proceeding with this project.

9. Several respondents to the Exposure Draft questioned the need for a Statement to specify

how an enterprise should classify an obligation that is callable by the creditor. They stated that the issues covered by the Exposure Draft are narrow, that adequate accounting guidance already exists, and that the exercise of judgment in the context of existing standards, such as ARB 43, Chapter 3A and Statement 6, provides satisfactory results. Other respondents said that the issues covered by the Exposure Draft are important practice problems that need an objective standard for resolution. Comments received on the Exposure Draft and other information received by the Board showed that, under similar facts and circumstances, significant diversity in reporting practices of enterprises exists with respect to the classification of obligations that are callable by the creditor. Accordingly, the Board concluded that this Statement should be issued.

Subjective Acceleration Clauses

10. The Exposure Draft disclosed the Board's intent not to address the effects of a subjective acceleration clause [3] in classifying a debtor's obligation. However, some respondents recommended that the Statement be expanded to include that issue since they believe it is similar to those currently being addressed and should be resolved in a consistent manner. Other respondents disagreed with the assertion in paragraph 13 of the Exposure Draft that, in principle, a long-term obligation that contains a subjective acceleration clause is callable by the creditor. They indicated that although compliance with the conditions of a subjective acceleration clause may not, by definition, be objectively determinable, such clauses do require the occurrence of some event of noncompliance, regardless of how subjective the determination of that occurrence may be, before the obligation can be called. Furthermore, they stated that the creditor must be "reasonable" in making any subjective determination to sustain a demand for repayment.

11. In determining the effect of a subjective acceleration clause on classification, FASB Technical Bulletin No. 79-3, *Subjective Acceleration Clauses in Long-Term Debt Agreements,* indicates that a debtor should assess the likelihood that the creditor will accelerate the debt's maturity under that clause, whereas this Statement does not permit a debtor to use such an assessment in determining the classification of obligations with objectively determinable provisions. The Board understands, however, that long-term debt agreements containing subjective acceleration clauses also typically include objectively determinable provisions, such as working capital or net worth requirements. The Board believes that creditors and debtors perceive a substantive difference between the rights that a creditor has under such a subjective acceleration clause and the rights that a creditor has under either (a) an obligation that is due on demand or (b) an obligation that is callable because of a violation of an objectively determinable provision. Accordingly, the Board has concluded that this Statement should not modify Bulletin 79-3.

Classification of Various Callable Obligations

12. Most respondents generally favored the proposals in the Exposure Draft and stated that requiring all callable obligations to be classified as current liabilities will promote more comparable financial reporting among various entities. Some respondents, however, disagreed

with the classifications that would be required for specific types of callable obligations and implied that classifying those obligations in a similar manner would create an unwarranted uniformity of presentation. Many of the latter respondents expressed the view that a callable obligation should be classified as a noncurrent liability if the creditor has not demanded repayment and there is no indication that the creditor intends to do so within the next year, a situation sometimes referred to as "continued forbearance." They maintained that classifying an obligation based on the discussion of current liabilities in ARB 43, Chapter 3A (particularly the phrase *reasonably expected to require the use of existing resources* in paragraph 7) would provide users of financial statements with the most useful information.

13. The Board believes that, for purposes of balance sheet classification, all obligations that are callable at the creditor's discretion are fundamentally alike and that the merits of setting an objective standard for determining classification outweigh the disadvantages. The Board further believes that assessments of liquidity and financial flexibility and comparisons of current liability positions may be obscured if the balance sheet classification of such callable obligations is based on the debtor's subjective expectations of the creditor's intent. Accordingly, the Board has concluded that, as a general principle, classification of debt in a debtor's balance sheet should be based on facts existing at the balance sheet date rather than on expectations. If the creditor has at that date, or will have within one year (or operating cycle, if longer) from that date, the unilateral right to demand immediate repayment of the debt under any provision of the debt agreement, the Board concluded that the obligation should be classified as a current liability unless (a) one of the conditions in paragraph 5 is met or (b) the obligation is expected to be refinanced on a long-term basis and the provisions of Statement 6 are met.

14. Some respondents disagreed with the provision of the Exposure Draft with respect to an obligation that is not currently callable but will become so within one year (or operating cycle, if longer) from the balance sheet date if an existing violation is not cured within a specified grace period. They stated that the obligation should be classified as a noncurrent liability because the creditor does not have the right to demand repayment at the balance sheet date and will not have that right within one year from the balance sheet date if the violation is cured or if the grace period will not expire within the next year (or operating cycle in both cases, if longer). They argued that requiring an obligation to be classified as a current liability in those circumstances negates the purpose of a grace period, which is to permit the debtor time to cure a violation without being subjected to its consequences. Other respondents agreed with the tentative conclusion of the Exposure Draft that would have required current classification in all such circumstances. They stated that classification of such an obligation should not be based on an assessment of the likelihood of future changes in circumstances, that is, on the debtor's assessment of the likelihood that the violation will be cured before the grace period expires.

15. Because the violation will make the obligation callable if conditions existing at the balance sheet date do not change within the grace period, the Board considers such liabilities to be presumptively current. However, because the creditor does not have the right to call the obligation at the balance sheet date, the Board believes that the presumption for current

classification can be overcome if it is also probable that the creditor will not obtain such a right under that provision of the debt agreement during the next year (or operating cycle, if longer). Accordingly, the Board concluded that such obligations should be classified as current liabilities unless it is probable that the violation will be cured within the grace period, thus preventing the obligation from becoming callable. This approach calls for an assessment of the probability that the debtor's own actions will prevent the creditor from *obtaining* the unilateral right to demand repayment within the next year; it differs from the approach favored by some respondents to assess the probability that another party (the creditor) will exercise an *existing* right. (Refer to paragraph 12.) Therefore, the Board believes that evaluating the probability that the violation will be cured within the grace period is not in conflict with the general principle described in paragraph 13 or with the classification required for the other types of callable obligations addressed by this Statement.

Other Matters

16. Some respondents suggested that the final Statement should distinguish between the consequences of significant violations of critical conditions and technical violations that are considered not to be of substance. They stated that implementation of the provisions of the Exposure Draft could result in serious and unintended consequences even in situations involving minor and easily correctable violations of debt agreement provisions. Other respondents said that the Exposure Draft substantially removes any auditor judgment in evaluating how an obligation should be classified when a violation exists. The Board believes that drawing a distinction between significant violations of critical conditions and technical violations is not practicable. A violation that a debtor considers to be technical may be considered critical by the creditor. Furthermore, a creditor may choose to use a technical violation as a means to withdraw from its lending relationship with the debtor. The Board believes that if the violation is considered insignificant by the creditor, then the debtor should be able to obtain a waiver as discussed in paragraph 5.

17. Some respondents recommended that the Statement be expanded to address the effect of a violation of a debt agreement that occurs between the balance sheet date and the date the financial statements are issued. Because accounting for events occurring after the balance sheet date is a pervasive issue that is beyond the scope of this project, the Board decided that consideration of that topic should not delay issuance of a final Statement.

18. Some respondents suggested that the Statement require specific disclosures when a debtor is in violation of a debt agreement provision. The Board concluded that existing disclosure practices for obligations classified as current liabilities are adequate. However, the Board decided to require disclosure of the circumstances for situations in which a debtor is in violation of a provision of the loan agreement but classifies the related debt as a long-term liability because it is probable that the violation will be cured within a specified grace period that extends beyond the date that the financial statements are to be issued.

19. Some respondents requested that additional time be provided for enterprises to implement this Statement to enable them to cure existing debt agreement violations or to renegotiate loan provisions that are likely to cause what they consider to be technical violations. The Board extended the effective date to include financial statements for fiscal years beginning after December 15, 1983 to be responsive to those concerns.

Footnotes

FAS78, Footnote 1--An obligation is *callable* at a given date if the creditor has the right at that date to demand, or to give notice of its intention to demand, repayment of the obligation owed to it by the debtor.

FAS78, Footnote 2--A *violation of a provision* is the failure to meet a condition in a debt agreement or a breach of a provision in the agreement for which compliance is objectively determinable, whether or not a grace period is allowed or the creditor is required to give notice of its intention to demand repayment.

FAS78, Appendix, Footnote 3--A *subjective acceleration clause* is a provision in a debt agreement that states that the creditor may accelerate the scheduled maturities of the obligation under conditions that are not objectively determinable (for example, "if the debtor fails to maintain satisfactory operations" or "if a material adverse change occurs").