



Determining the appropriate accounting for a debt transaction

Most companies use debt as an integral part of their capital structure to finance business operations and investments. Debt financing might take the form of loans from banks or other finance providers or the sale of debt securities to investors. Many companies have credit facilities that include lines of credit or revolving debt arrangements.

A company's determination of the appropriate accounting for a debt transaction is often time-consuming and complex. To properly apply the numerous rules and exceptions that exist in US GAAP, a company needs to closely analyze transaction terms and conditions and the related facts and circumstances. Terms that are significant to the accounting analysis may be buried deep within a contract's fine print or in separate legal agreements. Even minor variations in the way contractual terms are defined could have a material effect on the accounting for a debt arrangement. The outcome of the analysis could significantly affect the classification, measurement, and earnings impact of the debt arrangement and associated financial statement ratios. Therefore, a company might decide to involve accounting advisers with experience and knowledge of the complexities of debt accounting to help it arrive at appropriate accounting conclusions.

Here are five questions that a company may need to address as it determines the appropriate accounting for a debt transaction:

1 | What are the units of account in a debt issuance?

While many debt contracts represent one unit of account, some debt agreements consist of two or more components that individually represent separate units of account. Conversely, two separate agreements might represent one combined unit of account. When a company enters into a debt transaction that includes items that can be legally detached or exercised separately from the debt, the company must evaluate whether those items are required to be treated as separate units of accounting under GAAP. For example, such an evaluation might be required if a company issues debt together with warrants on its equity shares, commitments from a finance provider for additional debt, registration payment arrangements, or overallotment options. If a determination is made that such items represent separate units of account, the company may need to value them and allocate some of the debt proceeds and any related issuance costs and fees to them. For accounting purposes, this could cause the debt to be recognized at an amount different from its principal amount, even if it was issued at an amount equal to its stated amount. Further, each of the units of account might be subject to different accounting requirements. The identification of units of account in a debt issuance could have a significant impact on financial statement amounts and key ratios. A company that is required to impute a debt discount because of the allocation of debt proceeds, for example, would report interest expense in excess of cash interest paid. Further, some units of account might be subject to fair value accounting or other accounting approaches that affect the computation of net income.



2 | What is the accounting for debt terms that could alter contractual cash flows?

Debt instruments often include contractual terms that could affect the timing or amount of cash flows or other exchanges required by the contract. Examples of such terms include indexed principal or interest payments, a holder's right to require the company to repay the outstanding amount before the stated maturity date, the company's right to prepay the stated amount, terms that accelerate the repayment of principal or interest upon the occurrence of an event, term extension features, a right or obligation to convert the instrument into the company's equity shares, and foreign currency features. Under GAAP, an entity must evaluate such terms to determine whether they are required to be accounted for as derivatives at fair value separate from the debt in which they are embedded. If derivative accounting is not required, a company must determine whether other specialized accounting models are required to be applied, such as those that apply to participating mortgages, indexed debt, convertible debt, sales of future revenue, extendable increasing-rate debt, and exchangeable debt. The related accounting conclusions could have a significant impact on financial statement amounts and key ratios. If a contractual feature is subject to fair value accounting, for example, it could cause significant earnings volatility.

3 | What is the accounting for a modification, exchange, conversion, or extinguishment of debt?

In the current economic environment, some companies are modifying or replacing existing debt to take advantage of historically low interest rates. Other companies are modifying or restructuring debt terms in the face of liquidity issues or disruption caused by the COVID-19 pandemic. If a company is experiencing financial difficulties and the creditor has granted a concession, the transaction must be accounted for and disclosed as a troubled debt restructuring (TDR), in which case special guidance limits the ability to recognize a debt restructuring gain. When a company modifies or exchanges outstanding debt in a transaction that does not qualify as a TDR, it must evaluate whether the transaction should be accounted for as a modification or extinguishment of the original debt instrument. Special guidance applies to conversions of debt into the issuer's equity shares and modifications of lines of credit and revolving debt arrangements. The financial statement impact of a modification, exchange, conversion, or extinguishment could be significantly different depending on the accounting guidance that applies to the transaction. For example, reported earnings might be significantly different depending on whether a debt modification or exchange qualifies as a TDR and whether the terms are considered substantially different under GAAP. Under TDR accounting, a company cannot recognize a debt restructuring gain if the remaining undiscounted cash flows and any potential contingent payments equal or exceed the debt's carrying amount. However, there is no similar limitation on the ability to recognize a debt extinguishment gain or loss when a debt modification or exchange does not qualify as a TDR and the transaction involves substantially different terms. In this scenario, a debt extinguishment gain or loss must be recognized on the basis of the fair value of the new debt. If a modification or exchange does not qualify as a TDR and the terms are not substantially different, however, the effect of the revised cash flows is accounted for on a prospective basis.

4 | Should debt be classified as current or noncurrent?

The determination of whether debt should be presented as current or noncurrent on a classified balance sheet is governed by a variety of fact-specific rules and exceptions under GAAP. In the current economic environment, some companies have had to violate debt covenants. Special rules apply to such violations and the impact of waivers, cures, and grace periods. If a debtor violates an objectively verifiable debt covenant that makes an otherwise long-term obligation due on demand or payable on demand within one year of the balance sheet date, the debt might still qualify for noncurrent classification if the creditor grants a waiver before the financial statements are issued (or available to be issued) or a grace period applies and certain other conditions are met. Further, short-term obligations might

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qualify for presentation as noncurrent if the debtor has the intent and ability to refinance the short-term obligation on a long-term basis.



5 | Have financing arrangements been properly presented and disclosed (e.g., supply chain financing arrangements)?

In recent years, it has become increasingly popular for companies to provide their suppliers with access to arrangements in which a bank or other finance provider offers to purchase receivables held by the company's suppliers. Examples of such arrangements include supply chain financing—open account platforms that permit a company's suppliers to elect to sell trade receivables to one or more participating intermediaries and an entity's issuance of negotiable instruments (e.g., bills of exchange or electronic time drafts) to settle invoices. If a company has a trade payable arrangement involving an intermediary, it should consider how to appropriately present and disclose the amount payable. Although such arrangements are often structured such that continued trade payable classification is appropriate, a recharacterization of the amount payable as debt owed to the finance provider is required in certain circumstances. If the trade payable is recharacterized as debt, that has implications for the appropriate cash flow statement presentation of the related cash flows.

Accounting Roadmap

Deloitte's *A Roadmap to the Issuer's Accounting for Debt* provides a comprehensive overview of the application of US GAAP to debt arrangements, including the accounting guidance that applies as a company responds to the five debt accounting questions described previously.

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