

Appropriate Classification of Debt – Current Liability or Long Term Debt A Trap for the Unwary Lender and Borrower

By Owen P. Lalor

Would your company be solvent if its revolving debt was reclassified as current liabilities?

The Sarbanes-Oxley Act of 2002 (Act) created the Public Company Accounting Oversight Board (PCAOB) which is required to conduct a continuing program of inspections of registered public accounting firms. In those inspections, the PCAOB assesses the accounting firms' compliance with professional standards in connection with performance of audits, issuance of audit reports, and related matters. The Act requires the PCAOB to conduct those inspections annually for firms that provide audit reports for more than 100 issuers and at least triennially for firms that provide audit reports for fewer issuers. On August 26, 2004 the PCAOB released its initial reports on limited inspections of the Big Four accounting firms and identified significant accounting and audit issues. The PCAOB inspection staff found that each firm had clients that failed to comply with the provisions of Emerging Issues Task Force (EITF) No. 95-22, *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that Include both a Subjective Acceleration Clause and a LockBox Arrangement*. As a result of these findings the client companies had to restate their balance sheets to address GAAP exceptions due to the EITF 95-22 issue.

According to George Diacont, PCAOB director of registration and inspections, "In each of the instances where the accounting was wrong, the long-term debt should have been recorded as short-term debt. This is a serious matter where the amounts were material to the financial statements." The classification of debt can affect the current ratio, which shows the liquidity of a company.

It is a very common practice to include both a subjective acceleration clause and a required lockbox arrangement in

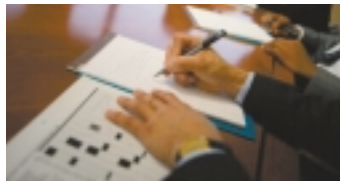
an asset based loan agreement. Where these provisions co-exist, however, the unsuspecting corporate borrower having a revolving credit facility in place with contractual repayment terms beyond one year from the balance sheet date, is in danger of misclassifying the outstanding loan balance as a noncurrent liability. Assuming the outstanding amount is material, the result is a material misstatement

of the balance sheet, which may ultimately create substantial liability to the users of the company's financial statements in addition to adversely impacting the company's ability to obtain new credit or maintain compliance with existing credit and financial responsibility regulatory requirements to which it may be subject.

Subjective Acceleration Clause

A subjective acceleration clause is a provision (or provisions) in a debt agreement that states that the creditor may accelerate the scheduled maturities of the obligation under conditions that are not objectively determinable (e.g., "if the debtor fails to maintain satisfactory operations" or "if a material adverse change occurs.") Financing agreements that are cancelable or subject to a reduction in availability based on a provision that can be evaluated differently by the two parties do not satisfy the objectivity requirement. Careful review of the entire credit agreement is essential to evaluate whether

compliance with the terms of the financing agreement is objectively determinable. A subjective acceleration clause may not be a separate part of the financing agreement in the form of a traditional material adverse change clause or within the agreement's specified events of default. Rather, it may be implicit in other aspects of the agreement, e.g., a lender's ability to reduce availability at its discretion. However, specific, quantifiable criteria in the financing



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agreement defining "material adverse change," such as a 10 percent decrease in working capital, sales and earnings, is considered to be "objectively determinable or measurable" allowing classification of the obligation as a noncurrent liability provided the other required conditions are met.

Required Lockbox Arrangement

A revolving credit agreement typically includes a requirement that the debtor maintain a lockbox. A required lockbox arrangement refers to a situation in which the debtor does not have the ability, without violating the agreement, to avoid using working capital to repay the amounts outstanding under the revolving credit facility. That is, the contractual provisions of the loan arrangement require, in the ordinary course of business and without another event occurring, that the cash receipts of the debtor be used to repay the existing obligation. The debtor must then request a draw down under the revolving credit facility. By operation of the lockbox arrangement, the bank always has first access to the collections remitted to the lockbox, and those collections are used to repay the revolving credit amount outstanding. (EITF 95-22).

Springing Lockbox Arrangements

A required lockbox arrangement should be contrasted with a "springing" lockbox arrangement. In a "springing" lockbox arrangement, payments made by the debtor's customers on the underlying collateral (accounts receivable) are remitted directly to the creditor. However, the remittances do not automatically reduce the debt outstanding; the remittances only reduce the outstanding borrowings if the creditor exercises the subjective acceleration clause or another "trigger" event occurs. A trigger event may be an event of default or any objectively determinable event, e.g., the amount of credit availability under the loan arrangement is less than a specified amount. As part of its cash management system, the debtor may voluntarily direct that remittances automatically reduce the debt outstanding, however, the debtor must retain the contractual right to revoke this directive or the lockbox will not qualify as a "springing" lockbox arrangement. The central issue is whether the debtor or the bank is contractually in control of the application of the remittances received in the lockbox. If the debtor is not in control there is no "springing" lockbox.

A revolving credit facility with contractual repayment terms beyond one year from the balance sheet date that includes both a subjective acceleration clause and a requirement to maintain a "springing" lockbox arrangement, as described above, is generally considered to be a

long-term obligation under EITF 95-22. An exception to this general statement occurs when the "springing" lockbox has "sprung" and the application of the remittances has fallen under control of the bank.

Lenders and borrowers should both be careful to negotiate the terms of revolving credit agreements with due regard for the implications of EITF 95-22 on the classification of the debt obligation being created. Lenders need to evaluate the impact the terms of the loan arrangement will have on classification of debt and the consequent determination of solvency, financial ratios and covenant compliance by their customer. Lenders will also want to be proactive to avoid negative consequences of subsequent reclassifications of revolving debt and resulting balance sheet restatements due to incorrect assumptions by the parties that the long-term credit facility would be treated as a noncurrent liability. Credit reviews should include verification that their customers' balance sheets properly classify the obligations to the bank. Lenders and borrowers should consider utilizing the guidance of EITF 95-22 to amend existing revolving credit facilities that include both a subjective acceleration clause and a required lockbox arrangement as appropriate to achieve desired debt classification.

Borrowers anxious to avoid events of default and technical insolvency resulting from classification of their revolving credit obligations as current liabilities should be proactive in the negotiation of their new loan arrangements or modification of existing loan arrangements. The benefits of using a "springing" lockbox arrangement rather than the traditional required lockbox arrangement may be substantial.

In any event, both lenders and borrowers should be aware, that the PCAOB's recent criticism of the Big 4 for lack of vigilant compliance with EITF 95-22 debt classification standards will result in greater scrutiny of revolving credit arrangements by auditors of public and closely held businesses alike. A proactive approach should reduce the burdens and potential for future liability arising out of misclassification of material debt in balance sheets.

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