Deloitte/FSA Faculty Consortium

The Deloitte/FSA Faculty Consortium this year will focus on various aspects of the conceptual framework definition of a liability. In three discussion sessions participants will discuss cases that illustrate issues in applying different aspects of the liability definition.

Session 1: Circumstances involving determining when a present obligation exists
Session 2: Constructive obligations
Session 3: Distinguishing liabilities and equities

These cases have been developed over the past few years for discussion by the FASB and IASB in the joint project to improve their respective conceptual frameworks. Some of these cases have also been used as conference materials for the Financial Reporting Issues Conference sponsored by the FASB, IASB and the six largest accounting firms.[1]

Participants are asked to be prepared to discuss all of the cases. Discussion leaders will select the order of the cases for small group discussions, to correspond with the desired full group discussion at the Consortium.

[1]These cases are to be used for educational purposes only—not for commercial use.

Session 1

Application of the Conceptual Framework Liability Definition

SFAC 6 defines liabilities and describes three characteristics of liabilities.

> Liabilities
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> 35. Liabilities are probable[21] future sacrifices of economic benefits arising from present obligations[22] of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
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> > [21]*Probable* is used with its usual general meaning, rather than in a specific accounting or technical sense, and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved. Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain. [References omitted.]
> >
> > [22]*Obligations* in the definition is broader than *legal obligations.* It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth. It includes equitable and constructive obligations as well as legal obligations. [References omitted.]
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> Characteristics of Liabilities
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> 36. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened.

In considering the following cases at the conference apply this concept rather than developing an answer based on standard level guidance.

Cases—Present Obligation

Case 1

Suppose a hospital has carried out a routine operation during which the patient died. If the patient's death was the result of hospital negligence, the hospital will have to pay compensation to the patient's dependents. The cause of death has not been established.

Two views of the situation are possible:

1. The event giving rise to an obligation is the performance of the operation. The entity has to stand ready to accept all the consequences of performing the operation, including the need to pay compensation if it has been negligent. It, therefore, has a stand-ready obligation that qualifies as liability.
2. The event giving rise to an obligation is the act of negligence. It is possible but not certain that the hospital has been negligent, so it is possible but not certain that it has a present obligation.

The first view would recognize as a liability the obligation to stand ready to take responsibility for any acts of negligence associated with the operation (with the ultimate amount to be paid being conditional on the occurrence or non-occurrence of uncertain events). Under this view, the uncertainty relates to the amount but not the existence of the obligation.

The second view raises recognition questions. Judgment is needed to determine whether an obligation exists and, therefore, a liability should be recognized. Should a probability threshold be applied? If so, what should that threshold be?

1. When do you think the hospital has an obligation that meets the definition of a liability?

Case 2

Smokey operates a factory in a jurisdiction that enacted legislation requiring smoke filters for all factories. The legislation, enacted in October, 2013 requires installation of the filters by December 31, 2014. A failure to meet the requirement will trigger a material fine assessed annually. The fine does not remove Smokey's obligation to install filters. As of December 31, 2013 Smokey has not installed filters.

1. At December 31, 2013 does Smokey have a liability?
2. At December 31, 2013 Smokey asserts he will not install the filters. Does Smokey have a liability for the anticipated fine?
3. If at December 31, 2014 Smokey has not installed filters, does Smokey have a liability to install filters?
4. If Smokey has not installed the filters and has a liability for a fine at December 31, 2014 is it only for the current year or for more than one year?

Case 3

A newspaper publishes many articles exposing information about people in the public eye. The people exposed sometimes sue for libel.

There are currently 10 claims being processed against the newspaper with respect to articles published before the end of the reporting period. Having examined the evidence available, the publisher expects two of the claims to be successful.

The newspaper has also identified five articles published for which no claim has been asserted but it is highly certain a claim will be made because of factual errors in the articles.

What liability, if any, does publisher have for these claims?

Case 4

Situation 1

Investor pays $X to an author to acquire contractual rights to future revenues from the sale of an existing book.

1. Does the investor have an asset?
2. Does the author have a liability?

Situation 2

Investor pays $X to an author to acquire contractual rights to future revenues from sales from a book yet to be written.

1. Does the investor have an asset?
2. Does the author have a liability?

Session 2

Constructive or equitable obligations are identified and explained in SFAC 6 of the present Framework. The explanation is not particularly helpful and many different circumstances seem to apply a notion of constructive obligations when resolving issues of liability recognition.

40. . . . , although most liabilities stem from legally enforceable obligations, some liabilities rest on equitable or constructive obligations, including some that arise in exchange transactions. Liabilities stemming from equitable or constructive obligations are commonly paid in the same way as legally binding contracts, but they lack the legal sanction that characterizes most liabilities and may be binding primarily because of social or moral sanctions or custom. . . . A constructive obligation is created, inferred, or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by government. For example, an entity may create a constructive obligation to employees for vacation pay or year-end bonuses by paying them every year even though it is not contractually bound to do so and has not announced a policy to do so.

Cases—Constructive Obligations

Case 1

The discussion in SFAC 6 suggests that a pattern of providing vacation pay or bonuses, with no contractual obligation to make those payments, may create a constructive obligation which would be a liability. Do you consider the following to be obligations?

1. An unvested defined benefit pension obligation.
2. Health care benefits to be paid to retirees; the contract allows the employer to modify the arrangement at any time.
3. Preferred stock dividends if the entity has a history of paying a 5% dividend for the past 20 years; is there an obligation before the declaration date?
4. Interest anticipated to be paid on the cash balance of an insurance contract in excess of the contracted minimum when an amount above the minimum has been paid for years.

Questions:

1. Do you consider the arrangements to be present obligations?
2. Do any of these arrangements create constructive obligations?
3. Are you influenced, in your conclusions, by phrases such as “little or no discretion to avoid the future sacrifice in paragraph 36 of SFAC 6?”
4. Are you aware of arrangements that would be considered moral (equitable) obligations? If so what are they? Do they give rise to liabilities that should be recognized?

Case 2

Emission Rights

A government issues emission rights or allowances and imposes an emission scheme intending to reduce certain emissions. Emission allowances are granted/issued in January of each compliance year that ends in December. By April of the following year participants must surrender emission allowances equal to their level of emissions during the preceding year.

Allowances granted by the government without cost to the participant may be sold and are actively traded. Pollute Company receives allowances (without cost) in January and expects to emit at levels which will require acquisitions of additional allowances in advance of the settlement date next April.

1. Does Pollute have an asset on the date it receives the allowances?
2. Does Pollute have a liability on the date it receives the allowances?
3. What should be the accounting consequence if Pollute sells the allowances in January when received?
4. If Pollute expects to acquire allowances in excess of those granted in January, when should the liability to acquire those allowances be recognized?
5. What should be the measure of either an asset or liability at initial recognition?
6. Should recorded assets or liabilities be remeasured as the market price of a right changes?
7. If the government plan is for 10 years with allowances granted annually, should future grants be anticipated in accounting for any assets and liabilities from the arrangement?

Other arrangements present similar and perhaps analogous circumstances.

1. A farmer is paid $100 per acre in advance to not grow a specified crop.
   a. Does the farmer have a liability if paid in advance?
   b. Does the farmer have an asset and liability prior to being paid if he is paid only *after* he does not grow the specified crop in the specified growing season?

2. Auto Company is given a tax abatement of $1,000,000 per year *if* it employs 1,000 people in a measurement period. Does Auto Company have an asset for the tax it will not have to pay? Does Auto Company have a liability to employ 1,000 workers?

3. Fairly Fast is given $5,000,000 on retirement from Football Club if he refrains from playing football with any other team. Does Football Club have an asset? Does Fast have a liability?

Case 3

A tax on particular revenue is levied on entities once a threshold of $5 million is reached. The tax is 1% of *every dollar* of revenue recognized over each 12 month period ending January 31. On December 31, an entity has taxable revenue of $4.9 million and it is virtually certain the $5 million threshold will be reached by the measurement date. At December 31, does the entity have a present obligation? If so is it a constructive obligation?

Case 4

Greenless is an extractive industry company that operates a mine in a jurisdiction that requires any extracted area to be filled once a depth of 100 feet below the original surface has been reached and mining ceases. At this year end Greenless has extraction sites that are 40, 60 and 90 feet deep. It is expected that all three sites will be approximately 200 feet deep before extraction is complete.

1. At this year end does Greenless have a present obligation?
2. Is it a constructive obligation?
3. Would your answer change if Greenless has been extracting minerals once a depth of 20 feet was achieved?

Case 5

TNT incorporated has issued $1,000 par value preferred stock at par. The stock contains the following terms:

- Annual, cumulative dividends at 5% of par value for first five years from issuance.
- TNT has the right to redeem the preferred stock at par at the end of five years from issuance.
- If TNT does not exercise its right to redeem the preferred stock, the cumulative dividend rate adjusts to 25%.
- If TNT fails to pay dividends annually, TNT is restricted from certain actions such as taking additional borrowings, paying dividends on other equity instruments, etc.

1. Does TNT have a constructive obligation?
2. How should TNT classify its preferred stock?

Session 3

Set Three: Cases—Liability or Equity: Obligation to do what?

In concept the SFAC definition is clear that for an obligation to meet the definition of a liability the entity must be required to deliver an asset of the obligated entity or provide a service. These cases ask you to analyze the concept that to meet the definition of a liability an entity must be obligated to deliver its own asset or perform services. In this analysis, you are asked to ignore current guidance, as the concept is not always applied.

Case 1

Major manufacturer has negotiated standard terms with all of its major suppliers. The terms allow Major to choose to settle all accounts payable by paying cash or issuing Major common stock.

1. If Major acquires materials from suppliers does Major have an obligation that meets the definition of a liability?
2. Should Major classify accounts payable as equity?

Case 2

Prosperous has a bonus plan; payment of the bonus is contingent on the achievement of defined targets. At December 31, the company year end, an employee has qualified for a $200,000 bonus that will be paid on January 31, whether or not the employee is still employed. Consider these alternatives:

1) The bonus will be paid in shares of Prosperous with fair value equal to $200,000 at the payment date January 31. Is there a liability at year end?
2) The bonus will be paid in 10,000 shares of Prosperous common stock at some point in the next fiscal quarter. At December 31, each share of Prosperous traded at $20 per share.

3) The bonus amount of $200,000 is determined based on the changes in fair value of Prosperous common stock by applying the following formula: the employee will receive $20,000 cash bonus for every $1 increase in Prosperous share price, starting from the specified date and ending December 31. The fair value of the stock increased from $10 per share at the specified date to $20 per share on December 31. Is there a liability on December 31 if the bonus is to be paid in cash?

4) Would your answer to the previous question change if the $200,000 was paid in common shares and not cash?

Case 3

High Flyer issues zero-coupon convertible bonds at a price of $9,600 per bond. The bonds are redeemable in 3 years for $10,000 and convertible at any time into 1,000 shares of High Flyer common stock. The fair value of High Flyer common stock at issuance date is $9 per share.

1. How would you propose to account for this arrangement?
2. How would this arrangement be accounted for under US GAAP? (Does it matter whether High Flyer is a public entity?)
3. Would your answers change if the bonds were issued at $10,800 per bond instead?
4. Would your answers change if the fair value of High Flyer common stock at issuance date was $12 per share?

Case 4

Great Dane issues preferred stock with the following features:

- $1,000 par issued at $960
- Shares in dividends with common stock
- Votes with common stock on certain defined matters
- Convertible at any time into 100 common shares (current fair value of a common share is $9).

- At the end of five years, if Great Dane has not affected an IPO, holders may put the preferred shares to Great Dane for par.

1. How would you propose to account for this arrangement?
2. How would this arrangement be accounted for under US GAAP?
3. Would your answers change if at issuance of the preferred shares, Great Dane does not have sufficient authorized shares to deliver if holders were to exercise the embedded conversion option?
4. Would your answers change if at the end of five years, holders could redeem the preferred shares at the greater of $1,000 or the fair value of the common shares underlying the conversion option?