la.hun.010 Analyzing measurement and recognition: Extending HBS Kansas City Zephyrs Case

This exercise examines expense recognition decisions in Harvard Business School’s Kansas City Zephyrs Baseball, Inc. case through the lens of current US GAAP. There have been significant changes to US GAAP since the case was written over twenty-five years ago, especially with regards to accounting for business combinations (such as acquiring another company). We’re also going to use the case to dig more deeply into recognition and measurement issues associated with the four-question OEC-Map approach we have been using to record entries:

- Should an asset be recognized?
- Should an asset be de-recognized?
- Should a liability be recognized?
- Should a liability be de-recognized?

If net assets (and thus owners’ equity) changes, use the OEC Map to identify the affected owners’ equity items.

This exercise has open-ended questions that allow for several good alternative responses. While there aren’t correct responses to the questions, some are definitely better than others. Generally, responses are better to the extent they identify and fully vet arguments, counterarguments, and rebuttals, include appropriate qualifiers, and provide insights regarding the way you assessed the relative merits of the arguments, counterarguments and rebuttals. See The Toulmin Model of Argumentation as a reference.

**Background Information**

**Asset Recognition**

**General**

We have seen that two criteria must be met to recognize a resource as an asset: the resource must satisfy the asset definition and it must be reliably measureable. These asset-recognition criteria are appropriate in all situations. However, there is a presumption under US GAAP and IFRS that the fair values of all identifiable assets acquired through a business combination can be measured reliably.

An asset is **identifiable** if it meets either of the following criteria:

a. It is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so.

b. It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable form the entity or from other rights and obligations.

**Financial Accounting Standards Board Glossary**

Assets that don’t meet these criteria are part of goodwill. Importantly, under US GAAP and IFRS identifiable assets are only presumed to be reliably measureable if they are acquired through a business combination (or separately purchased from a third party). As
a result, many identifiable intangibles such as brands, trademarks and customer lists are only recognized as assets if they were acquired from third parties (separately or through business combinations).

At the time they are acquired, identifiable intangible assets are classified as having or not having **definite lives**. Assets with definite lives are amortized over these lives. Assets without definite lives are not amortized, but they must be tested for impairment annually. For example, trademarks are often classified as intangible assets with indefinite lives. By contrast, patents are always classified as intangibles with definite lives.

**Kansas City Zephyrs**

There are two important asset recognition decisions in the KCZ case:

- **Signing bonuses**: Should signing bonuses be recognized as assets when paid and amortized over the years of the employment contracts or expensed immediately? Here you must determine whether signing bonuses meet the definition of an asset and if so, whether the future benefits can be measured reliably.

- **Initial roster depreciation**: For reasons given later, we are going to focus on a broader set of intangibles and the following questions: Assuming current GAAP had been applicable when KCZ was acquired, would one or more identifiable intangible assets have been recognized? If so, which of these would have been classified as having definite lives and thus been amortized?

When determining whether a specific intangible asset would have been recognized at the time KCZ was acquired, you will need to determine whether the asset meets one of the two criteria mentioned earlier: whether it is separable or arises from contractual rights. Here is a related quote regarding players’ contracts:

“Employment contracts may result in contract-based intangible assets or liabilities [ASC 805-20-55-36; IFRS 3.IE37]. An employment contract may be above or below market in the same way as a lease (see BCG 4.3.4.6) or a servicing contract. However, the recognition of employment contract intangible assets and liabilities is rare in practice. Employees can choose to leave employment with relatively short notice periods, and employment contracts are usually not enforced. In addition, the difficulty of substantiating market compensation for specific employees may present challenges in measuring such an asset or liability.

An exception might be when a professional sports team is acquired. The player contracts may well give rise to employment contract intangible assets and liabilities. The athletes often work under professional restrictions, such that they cannot leave their contracted teams at will and play with another team to maintain their professional standing. Player contracts may also be separable, in that they are often the subject of observable market transactions.”

_A Global Guide to Accounting for Business Combinations and Noncontrolling Interests Application of the U.S. GAAP and IFRS Standards, PWC, Section 4.3.4.2_

A player’s contract could be recognized as an asset or liability depending on whether it is above or below market at the time of the acquisition.

For example, suppose:

- A player signed a five-year contract one year before his team was acquired for $1.2 million per year.
- He had a fabulous first year under the contract.
- At the time of the acquisition, a comparable player would likely be paid $1.5 million per year for a four-year contract.

Given these facts:

- The acquiring team would record a “roster” asset for the present value of $0.3 million each year for the next four years ($0.3 = $1.5 - $1.2).
- Each year during the contract, the acquiring company would recognize:
  - (i) Interest income on the asset (based on the discount rate used to determine the present value).
  - (ii) The following compensation entry: increase (debit) compensation expense $1.5, decrease (credit) cash $1.2, and decrease (credit) the roster asset for $0.3.
Liability Recognition

General
We have seen that generally three criteria must be met to recognize an obligation as a liability: the obligation must satisfy the liability definition; it must be reliably measurable; and it must be probable. Under IFRS, an obligation is probable if a related outflow of resources is more likely than not to occur (greater than a 50% chance). Probable is not defined under US GAAP but is usually interpreted to mean somewhere between a 70-80% chance of occurrence.

Kansas City Zephyrs
There are two liability recognition decisions in the KCZ case:

- **Deferred compensation**: Should KCZ recognize a liability for compensation earned in the current year that will be paid in future years?
- **Nonroster guaranteed payments**: Should KCZ recognize a liability for future payments to the two injured players? At issue here is whether this contract is “onerous,” meaning the future benefits are expected to be less than the future costs, so a loss is expected. Recall that assets and liabilities associated with executory contracts are generally not recognized (where an executory contract is one where both parties have substantial remaining performance obligations). There is an exception when an executory contract is onerous.

Measurement

General
When analyzing financial statements, you need to qualitatively gauge the reliability of measures reported therein to assess the extent to which they should influence your conclusions. How faithfully do the numbers represent the underlying economic activity? To what extent would objective experts agree on the measures? Would objective experts’ measures for the same activity be widely dispersed, narrowly dispersed, or somewhere in between?

For example, we would expect objective experts’ measures of the fair values of cash and cash equivalents to be narrowly dispersed (where the fair value of an asset is the price it could be sold for to a willing buyer); their measures of the fair values of goodwill to be pretty widely dispersed; and their measures of the fair values of property, plant and equipment to be somewhere in between.

Three factors largely explain the dispersion of objective experts’ measures:

1. **The measurement objective, method, inputs and scope**. For example, the measurement objective might be fair value or adjusted historical cost. If the measurement objective was to determine the accumulated depreciation associated with the adjusted historical cost of PP&E, the measurement method might be straight-line or accelerated depreciation. If straight-line, the inputs would include the length of time the asset is expected to be in use and the estimated value of the asset at the end of this period. The scope of the measurement, also called the unit of account, refers to the number of items that are measured as one unit. For example, a building might be depreciated as a single unit of account or various parts of the building (roof, wiring, etc.) might be depreciated separately.

2. **Uncertainty associated with the underlying economic activities being measured**. Ceteris paribus (everything else equal), the greater the uncertainty, the wider the dispersion of objective experts’ measures. However, to the extent representative benchmark data is available, the dispersion associated with underlying uncertainty can be mitigated.

3. **Availability of representative benchmark data**. Measurement inputs are often based on estimates, which are averages or other statistics associated with samples of historical or cross-sectional data. For example, estimates of expected future receivable write-offs are often based on historical averages and estimates of assets fair values are often based on the average sales price of recent sales of comparable assets. Benchmark data is representative to the extent the related underlying economic activity is comparable to the economic activity being measured. For example, historical receivable write-offs are representative of expected future write offs when the economy is stable but not representative when economic conditions are rapidly eroding, as they did in 2008.

If all management teams were objective experts, you could gauge the reliability of reported numbers solely by assessing these three factors. To the extent objective experts’ measures would be widely dispersed, you also need to qualitatively gauge the objectiveness and expertise of the management team that prepared the numbers. For
some business activities, applying GAAP can be very challenging, allowing the possibility for honest errors. Also, to the extent objective experts’ measures would be widely dispersed, opportunistic management teams have room to manipulate reported numbers.

Standard setters tend to restrict measurement latitude when the dispersion of objective experts’ measures would otherwise be problematic because of honest errors or opportunistic reporting. A relevant example for this exercise is the criterion that resources can only be recognized as assets when they can be measured reliably. Still, as indicated earlier, reliability spans a very broad continuum and GAAP is silent regarding the threshold when measures become reliable enough for recognition. Instead, GAAP specifies situations where standard setters have concluded asset measures would not be reliable. Notable examples are the future benefits associated with research and advertising, whose costs must be expensed as incurred rather than capitalized as assets.

These examples highlight a subtle aspect of what it means to say an asset is reliably measureable. Typically, the issue is not whether the asset can be measured reliably when it is acquired. For example, the historical costs associated with research and advertising can be measured reliably. Rather, the bigger issue is whether the benefits expected to be received at future dates can be measured reliably. For example, there is considerable uncertainty regarding whether and when the benefits associated with most research will be realized. This means that if an asset was recognized when research costs were incurred, testing for impairment at future dates or otherwise determining when the asset should be de-recognized through amortization would be problematic.

Knowing how the availability of representative benchmark data affects the dispersion of objective experts’ measures can help you understand the evolution of GAAP. The availability of representative benchmark data has expanded greatly during the past couple of decades with the expansion of global markets and rapid evolutions in technology, which have resulted in “big data.” As better data has emerged, fair-value measurements have become more pervasive. In fact, they were largely nonexistent prior to 1990.

There is another aspect of GAAP that is particularly relevant to this exercise. Sometimes new standards are not consistent with existing standards that fall outside the scope of the new standards. For example, since 2008 when the IASB and FASB revised the business combination standards, there has been a presumption that the fair values of brands and other identifiable intangible assets acquired through a business combination can be measured reliably, yet the fair values of internally developed brands can’t be recognized because standard setters concluded long ago that internally developed intangibles can’t be measured reliably. This seems to be a glaring inconsistency: the measurement methods and inputs used to estimate brands’ fair values when a business is acquired and those used thereafter to determine whether and when the brands should be amortized or impaired are largely independent of the business combination. This suggests these methods and inputs would yield equally reliable measures for internally developed brands. As a result of this inconsistency, comparability across companies becomes problematic when some companies develop intangibles internally that others acquire them through business combinations.

**Kansas City Zephyrs**

The reliability of reported measures and thus the extent to which they should influence decisions is inherently contextual, depending, in particular, on the extent to which there is uncertainty about the related business activity and the availability of representative benchmark data. Accordingly, as you assess the reliability of various measures in the KCZ case and the extent to which you should weigh concerns regarding these measures raised by the players or owners, compare the availability of benchmark data in baseball and other sports to that available in other industries.

**Drill deeper - beyond the scope of this exercise.** A deeper discussion of measurement concepts and the factors that affect the dispersion of measures is beyond the scope of this exercise. To learn more, watch the following *Navigating Accounting* videos:

- “Measurement Decisions”
  [www.navigatingaccounting.com/video/scenic-measurement-decisions](http://www.navigatingaccounting.com/video/scenic-measurement-decisions)

- “Factors Diving the Dispersion of Ideal Measures”

- “Factors Diving the Dispersion of Actual Measures”
Part I: Signing bonuses

Your claim

(a) Fill in the blank with either players’ or owners’:

I support the ____________________________ accounting for signing bonuses.
[players’ or owners’]

Qualifiers

(b) Put an X at the spot on the scale on the next page that indicates the likelihood your claim is correct, given information provided here and in the case, concepts covered thus far, and your general understanding of baseball.

After completing (c)-(e), put an X at the spot on the scale below that indicates the likelihood your claim is correct, given the available information and concepts covered thus far. Your response should depend on the strength of your arguments, counterarguments, and rebuttals to counterarguments.

The Toulmin Method of Argumentation: The Second Triad, Keith Green
http://www.youtube.com/watch?v=gFlAIc1zZD8
Your opening remarks
Assume you are presenting your analysis to an audience and you have decided that your opening remarks will present your qualified claim and briefly preview the way you assess the relative strengths of your arguments, counterarguments, and rebuttals without explicitly stating them.

For example, you might state "Based on my analysis of available information, I have concluded that I support the players' accounting for signing bonuses. I will present three supporting arguments for this claim, two of which are very compelling. I will also present two counterarguments. I will thoroughly refute one of these, but I can't provide a reasonable rebuttal for the other, which has sufficient merit for me to qualify my claim as likely rather than probable."

(c) Write your opening remarks below:
Your arguments

Provide no more than three arguments in support of your claim in the space provided below, numbered and arranged according to your assessment of their strength (from strongest to weakest).

Consistent with The Toulmin Model, each argument should provide evidence, a warrant, and possibly backing for the warrant. You need not identify the components. For example, you needn’t state here is my evidence and here is its warrant. However, both must be present for each argument and while the warrant can be implied, the evidence and backing must be explicit. Keep in mind that the quality of your response depends more on the strength of the arguments you present rather than the number of arguments. For example, one exceptional argument may be all you need.

(d) Write your arguments below, conditional on concepts covered thus far, information provided here and in the case, and your general understanding of baseball.
Counterarguments and rebuttals
Provide no more than three counterarguments to your claim, numbered and arranged according to your assessment of their challenge to the claim (from strongest to weakest). If possible provide rebuttals immediately below each counterargument.

(e) Write your counterarguments and rebuttals below, conditional on concepts covered thus far, information provided here and in the case, and your general understanding of baseball.
Part II: Deferred Compensation

Your claim

(f) Fill in the blank with either players’ or owners’:

I support the __________________________ accounting for deferred compensation.  
[players’ or owners’]

Qualifiers

(g) Put an X at the spot on the scale on the next page that indicates the likelihood your claim is correct, given information provided here and in the case, concepts covered thus far, and your general understanding of baseball.

Follow the guidance for part (b).

Unlikely  Possibly  Likely  Probably

Absolute Uncertainty

Absolute Certainty

The Toulmin Method of Argumentation: The Second Triad, Keith Green
http://www.youtube.com/watch?v=-gRaC_2Z5D8
Your opening remarks

Assume you are presenting your analysis to an audience and you have decided that your opening remarks will present your qualified claim and briefly preview the way you assess the relative strengths of your arguments, counterarguments, and rebuttals without explicitly stating them.

Follow the guidance for part (c).

(h) Write your opening remarks below:
Your arguments

Provide no more than three arguments in support of your claim in the space provided below, numbered and arranged according to your assessment of their strength (from strongest to weakest).

Follow the guidance for part (d).

(i) Write your arguments below, conditional on concepts covered thus far, information provided here and in the case, and your general understanding of baseball.
Counterarguments and rebuttals
Provide no more than three counterarguments to your claim, numbered and arranged according to your assessment of their challenge to the claim (from strongest to weakest). If possible provide rebuttals immediately below each counterargument.

(j) Write your counterarguments and rebuttals below, conditional on concepts covered thus far, information provided here and in the case, and your general understanding of baseball.
Part III: Non-roster guaranteed payments

Your claim

(k) Fill in the blank with either players’ or owners’:

I support the ___________________________ accounting for non-roster guaranteed payments.

[players’ or owners’]

Qualifiers

(l) Put an X at the spot on the scale on the next page that indicates the likelihood your claim is correct, given information provided here and in the case, concepts covered thus far, and your general understanding of baseball.

Follow the guidance for part (b).

The Toulmin Method of Argumentation: The Second Triad, Keith Green
http://www.youtube.com/watch?v=-gRaC_ZCD8

© 1991-2013 NavAcc LLC, G. Peter & Carolyn R. Wilson
Your opening remarks

Assume you are presenting your analysis to an audience and you have decided that your opening remarks will present your qualified claim and briefly preview the way you assess the relative strengths of your arguments, counterarguments, and rebuttals without explicitly stating them.

Follow the guidance for part (c).

(m) Write your opening remarks below:

_________________________________________________________________________

_________________________________________________________________________

_________________________________________________________________________

_________________________________________________________________________

_________________________________________________________________________

_________________________________________________________________________

_________________________________________________________________________

_________________________________________________________________________

_________________________________________________________________________
Your arguments

Provide no more than three arguments in support of your claim in the space provided below, numbered and arranged according to your assessment of their strength (from strongest to weakest).

Follow the guidance for part (d).

(n) Write your arguments below, conditional on concepts covered thus far, information provided here and in the case, and your general understanding of baseball.
Counterarguments and rebuttals
Provide no more than three counterarguments to your claim, numbered and arranged according to your assessment of their challenge to the claim (from strongest to weakest). If possible provide rebuttals immediately below each counterargument.

(o) Write your counterarguments and rebuttals below, conditional on concepts covered thus far, information provided here and in the case, and your general understanding of baseball.

_________________________________________________________________
_________________________________________________________________
_________________________________________________________________
_________________________________________________________________
_________________________________________________________________
_________________________________________________________________
_________________________________________________________________
_________________________________________________________________
_________________________________________________________________
_________________________________________________________________
_________________________________________________________________
_________________________________________________________________
_________________________________________________________________
_________________________________________________________________
Part IV: Identifiable Intangible Assets

The final disputed issue in the KCZ case considered here centers on initial roster depreciation. The case doesn’t provide sufficient information about the initial roster asset to determine whether all or part of it would be depreciated under current GAAP. Perhaps the authors were intentionally vague to promote an open ended discussion of the wide range of related issues and judgments. Regardless, we are going to change the case facts here to facilitate an analysis of issues that would likely arise under current GAAP.

Specifically, assume:

- Current GAAP for business combinations was also authoritative guidance in 1982 when KCZ was acquired (this is not true).
- When KCZ was acquired in 1982, instead of allocating $12,000 to the initial roster (per the original case), we will assume the owners allocated it as follows:
  - $3,000 for the fair value of the KCZ brand
  - $3,000 for the fair value of the players’ contracts in excess of the value of the scheduled payments. These contracts all had 6 years of remaining life at the time of the acquisition.
  - $3,000 for the fair value of KCZ’s cohesive team culture. There was widespread agreement that KCZ won most of its games because the players were highly focused on team goals, rather than on individual accomplishments.
  - $3,000 to goodwill.
- The three intangibles other than goodwill were classified as identifiable assets with definite lives by the owners at the time of the acquisition and the owners decided to amortize them straight-line over six years ($1,500 per year). As a result, their combined book value was $4,500 at the end fiscal 1984.

Required

If you were asked to serve as a neutral arbitrator in the dispute between the players and owners and you concluded the initial measurements of the three intangibles identified above were all reasonable, what adjustments, if any, would you make to the $1,500 of related fiscal 1984 expense reported by the owners (in the modified case). Write your response in the space below, providing arguments defending your adjustments.

To this end, for each of the three intangibles, determine whether you agree with the owners that the item met the criteria to be an identifiable asset and thus not included in goodwill. If it does meet these criteria, do you agree that it should have been classified as having a definite life and thus that it should be amortized.
Part V: Summary

Required

(q) If you were asked to serve as a neutral arbitrator in the dispute between the players and owners, summarize the adjustments you would make, if any, to the 1984 expenses reported by the owners, restricting your analysis to the expenses in Parts I-IV and maintaining the assumptions in Part IV. If you conclude an expense should be excluded for the purpose of negotiating compensation, even if the expense would be recognized under GAAP, state your reasons for the exclusion.

Write your response below.