Nexia SAB&T
Training and Technical

LIABILITY – YES or NO?

Should it be **accrued** or **provided** for?

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This tip deals with the principle that a contractual or a statutory obligation in itself does not necessarily gives rise to a liability.

For example, an entity is obligated by law to pay income tax – however – in terms of accrual accounting principles, there is ***no obligation*** to pay tax unless *income has been earned*. The earning of the income is the past event that gives rise to the obligation to pay the tax. In this example, the liability is classified as a tax liability in accordance with IAS 12.

The most fundamental part of the liability definition is the need for a "**past event**" that will give rise to an obligation. This event must result in an entity having *no realistic alternative* but to settle the obligation by paying in cash or otherwise. Once a liability exists, an entity determines the classification of that liability based on the <u>nature</u> of the liability using the relevant IFRS standards or recognise the liability in terms of the "Framework", in the absence of a standard dealing with that specific type of liability.

The 'liability' definition

Past events (IAS 37.17 – .22)

There must be an event, and it must have happened on or before the reporting date (year-end) for it to be a past event.

Obligating events (IAS 37.17 – .22)

For there to be an obligation at year-end, there must be a past event that is also an obligating event. In simple terms, there must be an event that presents an actual performance by the parties to any transaction, other than a constructive obligation. The past event must create a situation where the entity has no realistic alternative but to settle the obligation.

Classification of liabilities

Different standards deal with the recognition of liabilities. It is important to know that <u>when a specific Accounting Standard deals with such an obligation, the obligation must be classified in terms of that Standard</u>. The scope of the Standard usually excludes the use of the provisions in that Standard to any obligation from another Standard (with certain exceptions).

For example, IAS 37 on Provisions specifically excludes obligations from *Income Taxes* (IAS 12), *Leases* (IFRS 16), *Employee Benefits* (IAS 19), *Insurance Contracts* (IFRS 4), Contingent considerations in a *Business Combination* (IFRS 3), *Revenue from contracts with customers* (IFRS 15) [except for constructive obligations which are included in IAS 37].

IAS 37 deals with both 'accrued expenses' and 'provisions'. The classification between an accrual and a provision is based on *judgement* and depends on the *degree of uncertainty*, either in timing or amount.

To note: It does not provide any disclosure requirements for accruals.

Examples

Dismantling and restoration – environmental

By law an entity is required to restore the land to its original state after mining activities have ceased. Mining activities consist mainly of drilling holes into the ground to facilitate the mining. Although it's required by law, there is no liability until the mine drills the holes. The drilling of the holes is the <u>obligating event</u>. The liability is recognised and classified in accordance with IAS 37 as no other standard deals with the provision for restoration costs.

Dismantling and restoration - leases

The contract stipulates that when the entity's lease ends the entity must dismantle the shelving and the dry walling and restore the space to its original condition. Although the contract requires the dismantling, the <u>obligating event</u> is the actual installation of the shelves and dry walling. Therefore the obligation is only recognised when the entity installs the shelves and dry walling. The liability is recognised in accordance with IAS 37 as either a provision or an accrual, depending on the level of uncertainty, and not in terms of IFRS 16 as this Standard does not deal with restoration costs incurred.

Leave benefits

The Basic Conditions of Employment Act stipulates that an employee must receive certain benefits. The 'legislation' does not give rise to the liability but the actual work performed by the employee gives rise to the <u>obligating event</u>. The liability is not an accrual or a provision in terms of IAS 37 but an 'employee benefit' in accordance with IAS 19. An entity applies IAS 19 principles in recognising, measuring and presenting the liability.

Audit fees

Despite a legal requirement to have an external audit or having a fixed contract for the provision of internal audit services, there is no obligation <u>until</u> the auditor performs the actual audit work. The obligation is measured based on the hours of work done until the end of the financial year and the rate per hour, and not the full fee relating to that financial year or the contractual fee for the internal audit services, i.e it excludes work done after year-end.

Without an <u>obligating event</u>, there is no obligation. The obligating event usually requires an action. Sometimes that action is the signing of a contract or a law or a service – for example. the non-cancellable portion of a lease, a licence fee that is due or an employee doing his/her job. How and when this obligation is recognised and presented depends entirely on the nature of the obligation.