LIABILITIES

Section 21 of the IFRS for SMEs (2015)

Provisions and Contingencies

Presenter details

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- **Welcome to the webinar!**

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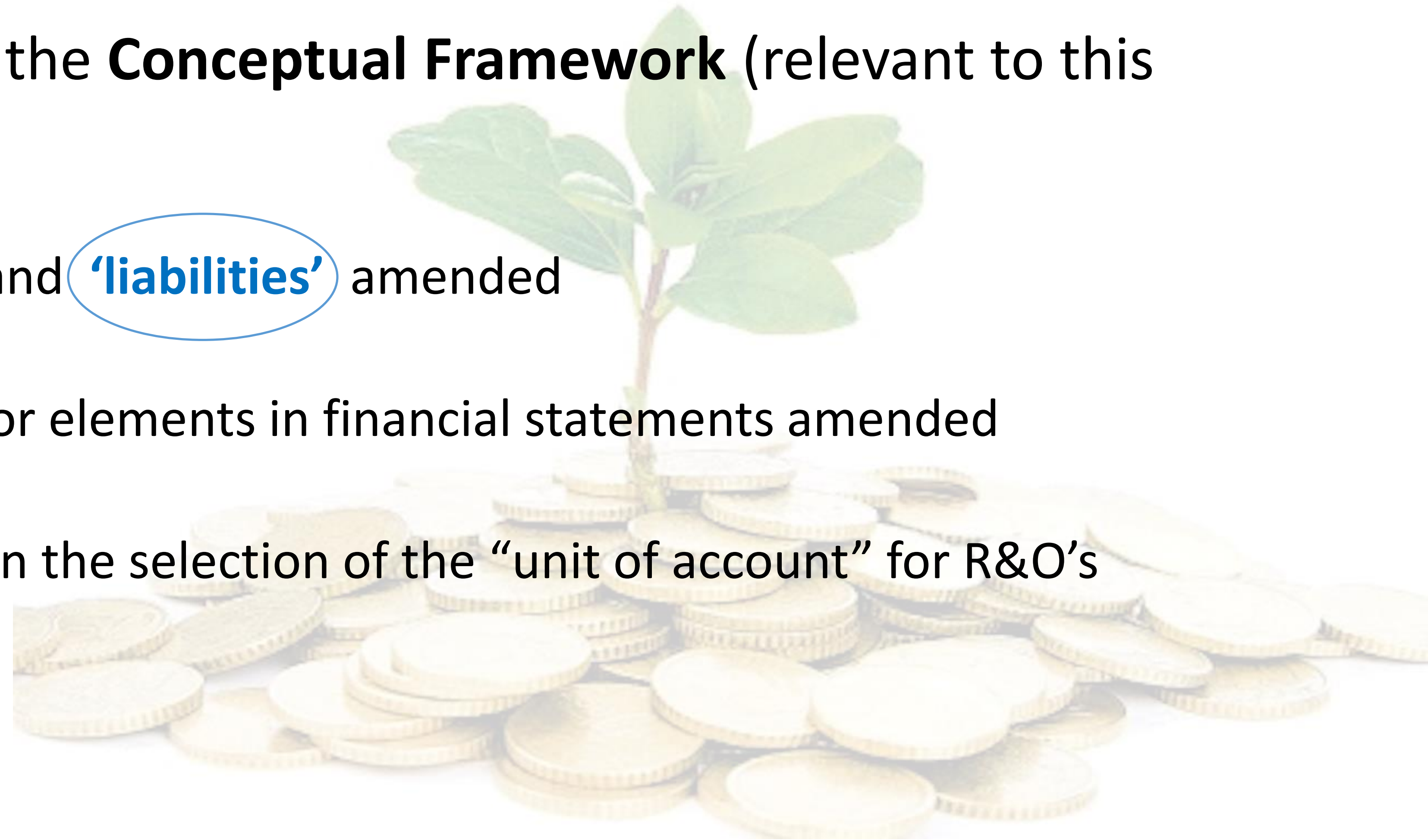
New developments on the horizon, i.t.o. IFRS

- **2018** amendments to the **Conceptual Framework** (relevant to this webinar):
  - Definition of ‘assets’ and **‘liabilities’** amended
  - **Recognition criteria** for elements in financial statements amended
  - Additional guidance on the selection of the “unit of account” for R&O’s



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Full IFRS: Conceptual Framework amendments (1)

- New definition for **'liability'**
  - **"A liability is a present obligation of the entity to transfer an economic resource as a result of past events"**
  - ~~*The settlement of which is **expected** to result in an outflow from the entity of resources embodying economic benefits*~~

It is important to note that the **expectation of an outflow** of resources, has been omitted in the 2018 amended Conceptual Framework

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Full IFRS: Conceptual Framework amendments (2)

- Amended **‘recognition criteria’** for all elements in AFS

  - **Relevance**
    - Incorporating probable economic benefit inflows/outflows and existence uncertainties and proper consideration of these, but no longer an “all-or-nothing” approach
  - **Faithful representation**
    - Incorporating the ability to reliably measure or estimate a relevant element as well as measurement uncertainties and proper consideration of these, but also not an “all-or-nothing” approach

  - ~~*Probable future economic benefit inflows/outflows*~~
  - ~~*Reliable measurement*~~

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Example of impact

Scenario

ABC (Pty) Ltd, the parent of financially-struggling **XYZ (Pty) Ltd**, enters into a loan agreement, in terms of which R10 million is provided to XYZ (Pty) Ltd as bridging capital. The loan has **no fixed repayment terms**.

Full IFRS application (if CF is applied):

The loan should be considered for recognition as a liability, as the expectation of cash flow to settle the liability does not automatically prohibit recognition, hence definition of liability is satisfied. Now consider RC…

IFRS for SMEs application (if CF is applied)

As there is no expectation of an outflow of economic benefits, it is questioned whether the "loan" should be recognised as a liability at all, or rather classified as equity… The definition of liability is NOT satisfied.

What is a liability i.t.o the IFRS for SMEs?

- A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits

- A **present obligation** exists when an entity has no *realistic* alternative but to settle the obligation

- Present obligations can be:
  - **Legal**
    - Binding contract/agreement
    - Statutory requirements (laws/acts)
  - **Constructive**
    - Derives from an entity's actions/behaviour

Often overlooked!!

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Restructuring provisions

- Separate rules exist!

- **A restructuring is a programme that is planned and controlled by management and materially changes either the scope of a business undertaken by an entity or the manner in which that business is conducted.**

- An entity recognises a restructuring provision ONLY when it has a **legal** or **constructive** obligation at the reporting date, to carry out the restructuring.

- A **constructive obligation** for restructuring only arises when an entity:
  - Has a **detailed formal plan** for the restructuring identifying at least:
    - The business or part of business concerned;
    - The principal locations affected;
    - The location, function and approximate number of employees who will be compensated for terminating their services;
    - The expenditures that will be undertaken; and
    - When the plan will be implemented; AND
  - Has raised a valid **expectation** in those affected that it will carry out the restructuring by starting to **implement** that plan or announcing its main features to those affected by it.

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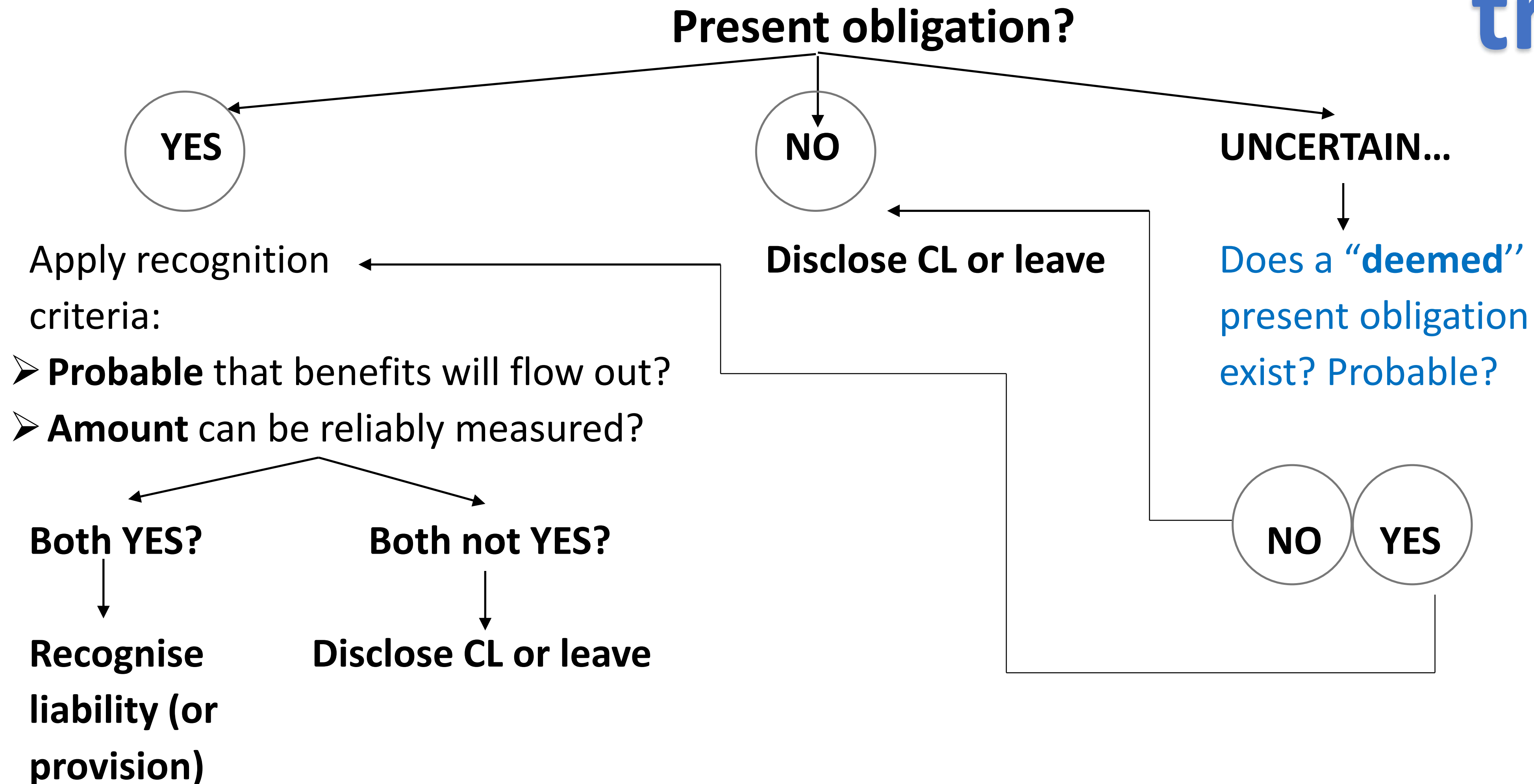
Case study 1

- On 22 February 2019, a customer of ABC (Pty) Ltd, Mr Jones, slipped on a wet floor and broke his leg. On 15 March 2019, two weeks after the financial year-end of the company, Jones instituted a legal claim against ABC (Pty) Ltd for R100 000 to cover alleged medical costs. On 20 March 2019, ABC (Pty) Ltd instituted a counterclaim for R100 000 against Cleaning (Pty) Ltd, the cleaning company responsible for cleaning the premises of ABC (Pty) Ltd, alleging that they had not put up proper signage indicating that the floor was wet, resulting in the fall of Jones. The financial statements were authorised for issue on 30 April 2019, at which time the legal claim was still unresolved.

- Accident 22/2/19 | Year-end 28/2/19 | Jones' claim 15/3/19 | ABC claim 20/3/19 | AFS issued 30/4/19

Does a present obligation exist?

Decision tree



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Application to case study 1

- It is clear that there is **uncertainty** about whether a present obligation exists for ABC (Pty) Ltd.
- ABC (Pty) Ltd therefore considers whether a **"deemed" present obligation** exists by consulting their legal advisers.
- If the legal advisers are of the opinion that it is **probable** (i.e. more likely than not) that ABC (Pty) Ltd has a present obligation to Mr. Jones, ABC (Pty) Ltd has a **deemed present obligation** and will continue to assess the recognition criteria:
  - Is it **probable** that money will flow from ABC (Pty) Ltd – remember: not all parties with present obligations are found guilty in court…
  - Can the amount of the claim be **reliably measured** by the legal advisers?
- If the legal advisers **do not** hold the opinion that ABC (Pty) Ltd has a deemed present obligation, a **contingent liability** is disclosed in the notes to the financial statements at 28 February 2019, unless possibility of settling the claim is "remote"
- Assume the legal advisers' professional opinion to be that ABC (Pty) Ltd:
  - Has a deemed present obligation (i.e. they should have ensured that a sign was put up);
  - Will be found guilty by the judge; and
  - Will have to pay an amount of R80 000 to Mr. Jones to reimburse him for his actual medical costs.
- **RESULT**: ABC (Pty) Ltd will **recognise a provision** for legal claim to the amount of R80 000 at their financial year-end (28 February 2019). The addressed uncertainty relates to the amount of the claim.

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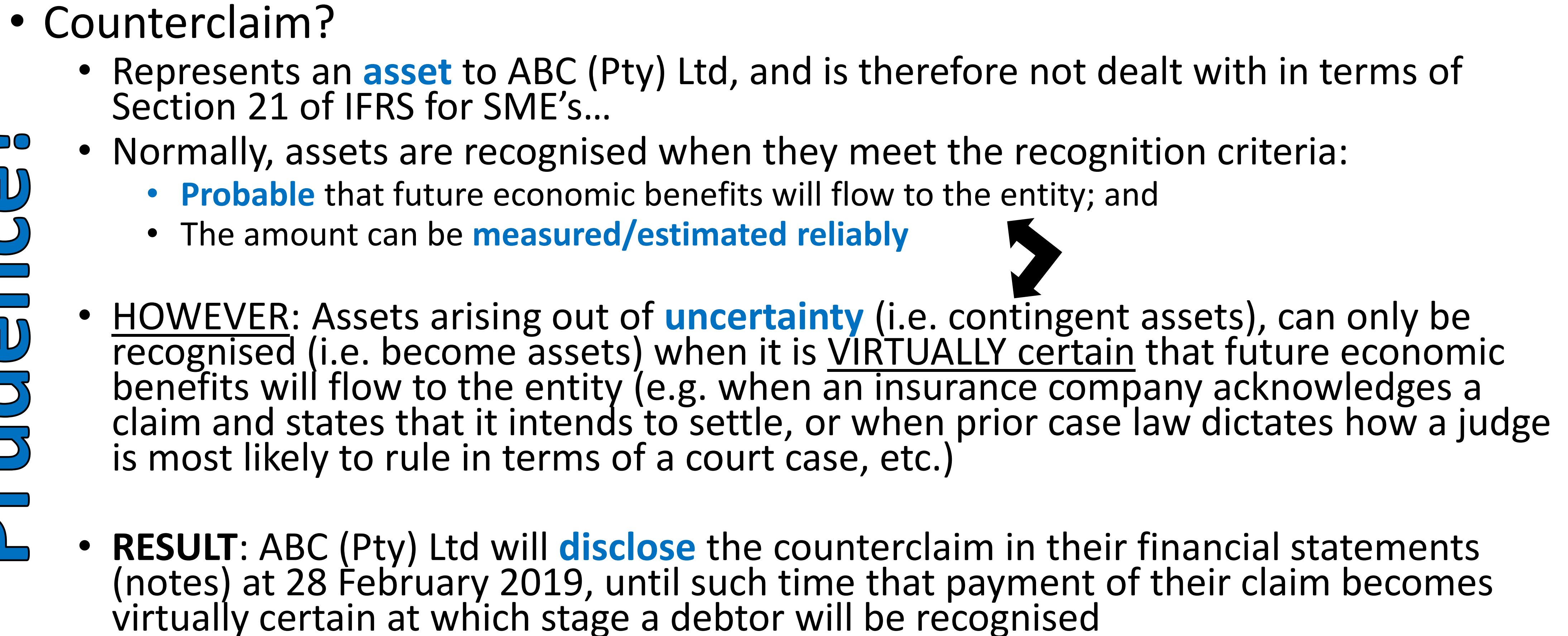
Application to case study 1 (cont'd)



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Case study 2

Company X (Pty) Ltd pollutes the environment by means of smoke released by their factories. During the current financial year, **legislation became effective** which dictates all air-polluting entities to fit smoke filters to their factories with immediate effect. The cost of such filters for X (Pty) Ltd will be R5 million. The legislation determines that companies in breach of law will be fined R1 million when identified. By 28 February 2019, the financial year-end of X (Pty) Ltd, the company had not fitted smoke filters **and** had not been fined for their neglect either. The company's luck unfortunately ran out and they were found and fined R1 million for air pollution on 20 March 2019. The financial statements were authorised for issue on 30 April 2019.

- *Will a **liability/provision** be recognised, or a **contingent liability** disclosed or **nothing be done** in the financial statements of X (Pty) Ltd as at **28 February 2019**?*

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"Avoidance test" – the crux of present obligation

- S21: Only those obligations that exist INDEPENDENTLY from the future actions of an entity, may be <u>recognised</u> as liabilities
  - Existing liabilities cannot be dependent/conditional on any further action/lack of action

- *Therefore: CAN THE OBLIGATION BE AVOIDED by the entity acting in a certain way, or not acting in a certain way, as at a specified date (usually year-end)?*

- If the obligation cannot be avoided in any realistic (legal) way, the entity is presently obligated
- If the obligation can be avoided in a realistic (legal) way, the entity is not/not yet presently obligated

- *Statutory obligations are often a good example of the risk of incorrect recognition*

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Application to case study 2

- <u>At financial reporting date</u> of X (Pty) Ltd, it can avoid the settlement of the following statutory obligations:

  - ***The obligation to fit smoke filters of R5 million – HOW?***
    - X (Pty) Ltd can stop polluting the air by changing their activities (green initiatives etc.)
    - X (Pty) Ltd can sell their factory
    - X (Pty) Ltd can close their business completely

  - ***The obligation to pay a fine of R1 million – HOW?***
    - X (Pty) Ltd can fit smoke filters before getting fined
    - X (Pty) Ltd can stop polluting the air by changing their activities
    - X (Pty) Ltd can sell their factory
    - X (Pty) Ltd can close their business

- It is therefore clear that X (Pty) Ltd has <u>no present obligation</u> in respect of the above two statutory obligations and will not recognise any amount as a liability or a provision

- X (Pty) Ltd is technically required to disclose a contingent liability in respect of the above two statutory obligations in the notes to the financial statements
  - Prejudicial disclosure?
  - Non-compliance with legislation is an audit issue?

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Case study 3

- A client purchases a ticket for R2 000 from SA Airline Company (SAAC) on 21 August 2019 to fly from OR Tambo International Airport to Cape Town International Airport, on 22 December 2019. The client pays for the ticket using his credit card. The terms and conditions on the ticket clearly state that the ticket is non-refundable.
- It may be assumed that 10% of the ticket price is allocated to the performance of administration and booking activities.
- Ignore VAT in this transaction.
- Assume the effect of the time value of money, to be immaterial.

- **Required:**
  - How and when should SAAC recognise and measure the above sales transaction in their financial accounting records, on the relevant dates?

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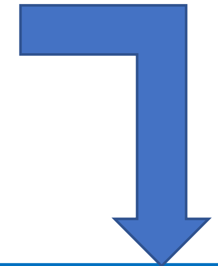
IFRS 15 *Revenue from Contracts with Customers*

- **Focus is not on revenue, but rather on liabilities (performance obligations)**



- Definition of liability therefore very important for revenue recognition

- **"Revenue recognised to the extent that liability is extinguished/discharged"**

- **5-step model per IFRS 15 (highly likely to be incorporated in IFRS for SMEs very soon):**
  - Step 1: Identify the contract that will generate the revenue
  - Step 2: Determine the relevant underlying **performance obligations** in the contract
  - Step 3: Determine the contract price
  - Step 4: Assign the contract price to each performance obligation, based on stand-alone prices
  - Step 5: As the performance obligation is extinguished, the revenue is recognised (over time/at a point)

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Application to case study 3

- When the ticket is **sold**, SAAC has a **performance obligations** to:
  - Fly the customer to Cape Town from Johannesburg on 22 December 2019. They have however been paid, and therefore the cash payment was received in advance for this performance obligation; and
  - Perform administrative and booking services relating to the requested flight.
- SAAC will only be able to recognise the money received as revenue once the relevant performance obligations have been satisfied:
  - Flight to Cape Town: only once the flight has been performed
  - Administration and booking: when the ticket is booked and processed on the SAAC system
- ***What about the terms and conditions stating that the ticket is non-refundable?***
- Journal entries for SAAC:
  - 21 August 2019 (date of sale of ticket):

	Dr	Cr
Dr Bank	2 000	
Cr Revenue – admin and booking service (P/L)		200
Cr Income received in advance (F/P)		1 800

  - 22 December 2019 (date of flight):

	Dr	Cr
Dr Income received in advance (F/P)	1 800	
Cr Revenue (P/L) – flights		1 800

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Provisions and Contingencies

- Section 21 of the IFRS for SME's
- Scope
  - Applies to **all** provisions, contingent liabilities and contingent assets
  - Including:
    - **Provisions** relating to leases (only in respect of operating leases that have become onerous)
    - **Provisions** relating to construction contracts
    - **Provisions** relating to employee benefit obligations
    - **Provisions** relating to income tax

    - *The <u>liability</u> elements of the above 4 items are dealt with in own sections in the IFRS for SME's*

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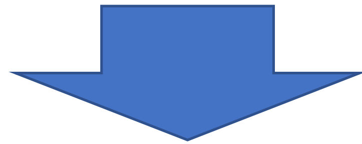
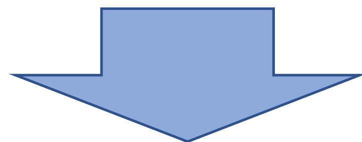
3 Tiers of Liabilities

- **Outright liabilities – RECOGNISED**
  - No uncertainty in respect of present obligation
  - No uncertainty in respect of timing or amount



- **Provisions – RECOGNISED**
  - No uncertainty in respect of present obligation
  - (Addressed) uncertainty in respect of timing or amount



- **Contingent liabilities – DISCLOSED OR LEFT, NEVER RECOGNISED**
  - Uncertainty in respect of present obligation
  - (Unaddressed) uncertainty in respect of timing or amount

LOW
UNCERTAINTY?
HIGH

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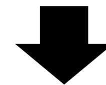
Provisions

- A provision **is a liability** of *(addressed)* uncertain timing or amount

- Recognised only when:
  - Entity has an **obligation** at the reporting date as a result of a past event;
  - It is **probable** (i.e. more likely than not) that the entity will be required to transfer economic benefits in settlement; and
  - The **amount** of the obligation can be estimated reliably.



Addressed uncertainty!

Changes in this amount are therefore regarded "changes in estimates"!

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Case study 4

- Company A Ltd is a public non-listed entity. Their annual audit takes place within two months after their year-end. No interim audit is performed. The annual audit fee increases only by inflation (6% per annum) and was R1 million for the previous financial year.
- The chief financial officer (CFO) of A Ltd has asked your opinion on whether a ‘provision for audit fees’ should actually be recognised by the company at reporting date, seeing that none of the audit work has been performed by the auditors by that date.

- **Required:**
  - Provide your opinion on the abovementioned question of the CFO of A Ltd.
  - Assume A (Pty) Ltd is a private company instead, with a public interest score of 68 and is owner-managed. Would your answer in respect of the above, differ? And if so, how?

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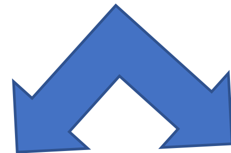
Past *(obligating)* event

- Very important to search for the correct **obligation-creating event** for each liability (and provision)

- Which actual event creates the obligation for the entity, and HOW?

- Is the event a PAST event? What does that mean?



- **Past events** versus **events after the end of the reporting period** ("post-balance sheet events")

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Application to case study 4

- A Ltd is a public, non-listed entity that has to be audited in terms of the Companies Act of 2008 (i.e. legal obligation)

- The company has no realistic alternative but to be audited and to settle the fee of the audit

- The past obligating event of the company is the trading of the company which necessitates ('triggers') the audit
  - The past obligating event is NOT the audit work performed!!

- The provision for audit fees survives the avoidance test, as the company will have to be audited and there is nothing that can be done to avoid that (even in liquidation, an audit will be performed) = legal obligation

- **It would be appropriate for A Ltd to recognise a provision for audit fees at reporting date**

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Application to case study 4 (cont'd)

- A (Pty) Ltd is a **private company** that is owner-managed with a P.I.S. of less than 100
- The Companies Act of 2008 does not require for such a company to be audited – there is therefore **no legal obligation** to be audited
- How to decide?
  - Does the MOI require an audit?
    - Yes: A provision for audit fees should be recognised
    - No: A provision for audit fees should NOT be recognised
- A case can be made that A (Pty) Ltd has a **constructive obligation** to be audited based on the fact that their past behaviour (i.e. electing to be audited since 2008) has created a valid expectation in those affected (the auditors) that the company will act in a certain way (i.e. be audited and pay for the audit)
- Should such a liability be a provision, or an outright liability? Where is the uncertainty?
- What about the matching concept? Shouldn't the cost of an audit be matched to the P/L of the period being audited, instead of in the next financial year?
- Some have even argued that the provision is recognised based on the principle of an onerous contract ☺

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Case study 5

- Company G (Pty) Ltd applies the IFRS for SME's in their annual financial statements. The company leases its head office building in terms of an operating lease at R100 000 per month. The company decided on 28 February 2019 (their financial year-end) to vacate the current building and move their head office to another building in a better location. The lease contract can be cancelled, which would incur G (Pty) Ltd a cancellation penalty of R1 million, or G (Pty) Ltd can sub-lease the building to another tenant at R80 000 per month for the remainder of the operating lease contract. There are 36 months left on the lease contract as at the financial year-end of the company.

- **Required:**
    - What would the journal entries be in terms of the above information to comply with the requirements of the IFRS for SME's as at 28 February 2019?
        - *Assume a nominal post-tax discount rate of 7.2% per annum*

Onerous contracts

- **An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.**

- If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.
- Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of this Standard and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of this Standard.

- The unavoidable costs under a contract reflect the **least net cost of exiting** from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.
- Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract.

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Application to case study 5

- The **least net cost of exiting the contract** needs to be calculated:

- Cost of fulfilment:
  - R100 000 – R80 000 = R20 000 per month excess (being the loss per month)
  - Discounted at 10% per annum for 36 months (7,2%/72%)
  - PV = R619 825

- Cancellation penalty:
  - R1 million

- **Least** net cost of exiting the contract shall be provided, i.e. R619 825

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Application to case study 5 (cont'd)

- **Journal entries at 28 February 2019**

	Dr	Cr
Dr Operating lease expense (P/L)	R619 825 ☹	
Cr Provision for onerous contract (F/P)		R619 825

- **Journal entries at 29 February 2020** (assume building is sub-leased)

	Dr	Cr
Dr Operating lease expense (P/L)	R1 200 000	
Cr Bank		R1 200 000
Dr Bank	R960 000	
Cr Rental income (P/L)		R960 000
Dr Interest on onerous contract (P/L)	R53 592	
Cr Provision for onerous contract (F/P)		R53 592
Dr Provision for onerous contract (F/P)	R240 000	
Cr Operating lease expense (P/L)		R240 000

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Executory contracts

- Contracts that are concluded, but **not yet complete** (i.e. legally speaking)
- Both parties have not performed at all, OR both parties have performed to the same extent
- The rights and obligations in executory contracts, are accounted for on a net basis
- Executory contracts don't fall in the scope of Section 21, **unless they are onerous**

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Executory contracts: example

- A (Pty) Ltd places a non-cancellable order for inventory to the value of **R1 million**, from B (Pty) Ltd. No payment is made as a deposit when the order is placed. A (Pty) Ltd will be able to sell the inventory at a profit, once received from the supplier. As the inventory is specialised, it takes two months to manufacture. It will only be delivered to A (Pty) Ltd after its year-end.
  - The order is therefore an executory contract, as the contract is incomplete and both parties have not performed at all.
  - As the order (contract) is not onerous (loss-making), it falls outside of the scope of Section 21 of the IFRS for SMEs.
  - The *rights to inventory* and the *obligation to pay for the inventory*, will therefore be accounted for on a NET basis by A (Pty) Ltd, and will not be separated from each other.

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Measurement of provisions

- **Initial measurement**
  - PV of expected future cost of settling the obligation (if effect of time value of money is material)
  - Gains from the expected disposal of assets must be <u>excluded</u> from the measurement of a provision
  - Reimbursement from third parties, for settling the provision:
    - Disclosed as contingent asset in notes to AFS
    - Recognised as asset only when <u>virtually certain</u> to occur
    - Amount recognised for reimbursement is limited to amount of provision
    - SoFP: Asset and provision presented separately!
    - SoCIE: Expense and reimbursement may be offset and presented on a net basis
  - Debit side of provision is an expense, unless an asset is more appropriate (e.g. IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities)*

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Case study 6

- Company X (Pty) Ltd owns plant with a cost price of R50 million (excl. VAT). The expected future cost to dismantle the plant after 20 years is R10 million (excl. VAT). An appropriate nominal pre-tax discount rate is 10% per annum. The plant is depreciated over 20 years and there is no residual value. Plant is not revalued in terms of the IFRS for SME's.
- Calculations:
  - *PV of R10 million at 10% p.a. for 20 years = R1 486 436*
  - Journal to recognise plant at initial recognition:
    - Dr Plant R50 000 000
    - Cr Bank/Creditors/LTL R50 000 000
    - Dr Plant R1 486 436
    - Cr Provision for dismantling (F/P) R1 486 436

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Case study 6 (cont'd)

- Assume that for year 1, the estimates remain unchanged.
- Journal entries:
  - Dr Interest expense (P/L) R148 644
  - Cr Provision for dismantling (F/P) R148 644

- Assume for year 2, that the discount rate changes from 10% p.a. to 9% p.a. on the first day of the year. New PV = R1 944 897
- Journal entries:
  - 1st day of Year 2:
    - Dr Plant (R1 944 897 – R1 635 080) R309 817
    - Cr Provision for dismantling (F/P) R309 817
  - End of Year 2
    - Dr Interest expense (P/L) R175 040
    - Cr Provision for dismantling (F/P) R175 040

IFRIC 1

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Case study 7

- A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale, the manufacturer undertakes to make good, by repair or replacement, latent manufacturing defects that become apparent within three years from the date of sale. On the basis of experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

- How should the above be accounted for i.t.o. Section 21 of the IFRS for SMEs?

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Application to case study 7

- Present obligation as a result of a past obligating event—the obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.
- An outflow of resources embodying economic benefits in settlement—probable for the warranties as a whole.
- Conclusion—the entity **recognises a provision** for the best estimate of the costs of making good under the warranty products sold before the reporting date.
- *How measured?*

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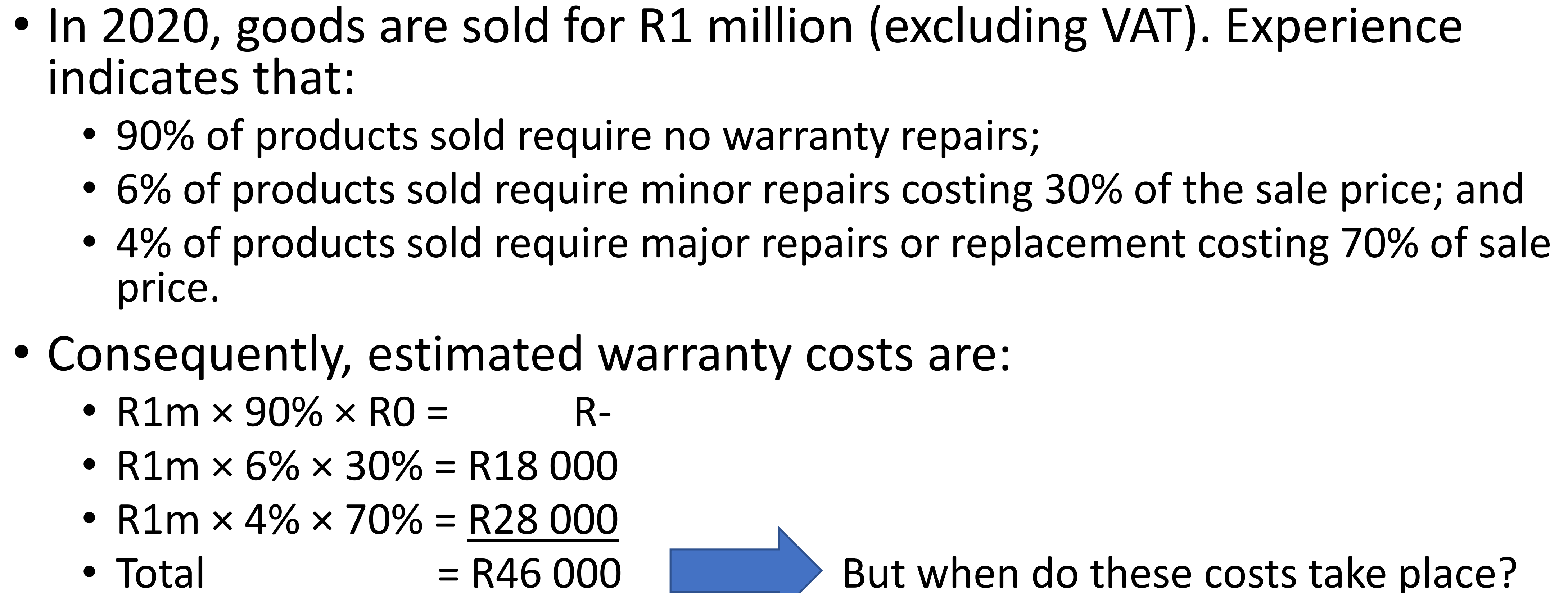
Application to case study 7 (continued)



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Application to case study 7 (continued)

- The expenditures for warranty repairs and replacements for products sold in 2020 are expected to be made 60% in 2021, 30% in 2022 and 10% in 2023, in each case at the end of the period.
- Because the estimated cash flows already reflect the probabilities of the cash outflows, and assuming there are no other risks or uncertainties that must be reflected, to determine the present value of those cash flows the entity uses a 'risk-free' discount rate based on government bonds with the same term as the expected cash outflows (6% for one-year bonds and 7% for two-year and three-year bonds).

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Application to case study 7 (continued)

- Calculation of the present value, at the end of 2020, of the estimated cash flows related to the warranties for products sold in 2020 is as performed as follows:

Year	Expected cash payments (R)	Discount rate	Discount factor	Present value (R)
1	60% × R46 000 = R27,600	6%	0.9434 (6% for 1 year)	R26 038
2	30% × R46 000 = R13,800	7%	0.8734 (7% for 2 years)	R12 053
3	10% × R46 000 = R4,600	7%	0.8163 (7% for 3 years)	R3 755
			Total	**R41 846**

- The entity will recognise a warranty obligation of R41 846 at the end of 2020 for products sold in 2020.

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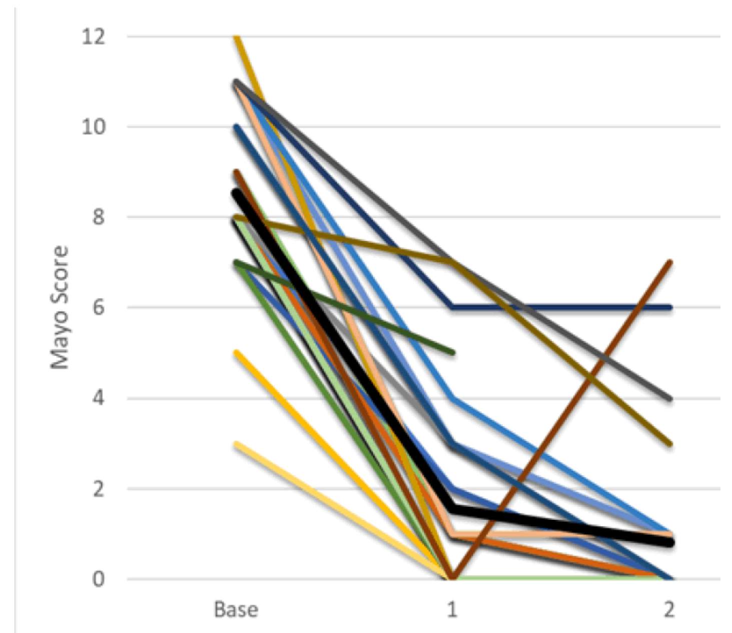
Measurement of provisions (cont'd)

- **Subsequent measurement**
  - Only those expenditures for which the provision was originally recognised, may be charged against a provision
  - Provisions are estimates, and are therefore reviewed at each reporting date
  - Changes in estimates are recognised in profit or loss, unless capitalised to assets per IFRIC 1
  - Where provisions are measured at present value, the unwinding of the effect of discounting shall be recognised as finance cost in profit or loss



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Disclosure of provisions (notes to AFS)

- For **each class of provision**, the following is disclosed in the notes to the AFS:
  - A reconciliation showing:
    - The CA at the beginning and end of the period
    - Additions during the period (including adjustments due to changes in estimates)
    - Amounts charged against the provision during the period
    - Unused amounts reversed during the period
  - Brief description of the nature of the obligation and the expected amount and timing of any resulting payments
  - Indication of the uncertainties about the amount or timing of those outflows
  - The amount of any expected reimbursement (stating which amount has been recognised as an asset for that reimbursement)
- Comparative information for prior periods is not required
- Where disclosure is ever impracticable, that fact must be disclosed in the notes to the AFS as well, including reasons why impracticable

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Disclosure of contingent liabilities (notes)

- Only if the possibility of outflow of resources, is not remote
- For **each class of contingent liability**, the following:
  - A brief description of the nature of the contingent liability
  - An estimate of its financial effect (if practicable)
  - An indication of the uncertainties relating to the amount or timing of the outflow (if practicable)
  - The possibility of any reimbursement (if possible)

- Where disclosure is ever impracticable, that fact must be disclosed in the notes to the AFS as well, including reasons why impracticable

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Disclosure of contingent assets (notes)

- Where assets arise out of uncertainty and likelihood of inflow of economic benefits is less than ‘virtually certain’, the following is disclosed:
  - A description of the nature of the contingent assets at the end of the reporting period
  - An estimate of the financial effect (only if practicable without undue cost or effort)

- Where disclosure is ever impracticable, that fact must be disclosed in the notes to the AFS as well, including reasons why impracticable

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Thank you for watching this webinar

- Should you have any questions about the content of the webinar, please contact the presenter, **Anton van Wyk**, using the following details:
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