South African Institute of Taxation

Credit check

A conversation about liabilities

YOUR KEY TO THE TAX COMMUNITY

Welcome

On the lunch plate today

1. **Tax focus points** touching on liabilities

2. **Accounting focus points** touching on liabilities **(S21 of IFRS for SMEs)**
    a) **Defining** a ‘present obligation’
    b) **Classifying** (the types of) liabilities
    c) **Practical application** through case studies
        i. Case studies 1 to 5 = covered
        ii. Case studies 6 to 7 = self-study

3. Conclusionary remarks

Tax focus points touching on liabilities

1. **Expense (debit) to P/L**
   - No cost actually incurred
   - Reverse the accounting movement (movement in provision balance and unwinding of provision)
   - Be careful of capitalised provisions! Capital allowances not impacted

2. **Balance (credit) in statement of financial position**

Section 11(a)

11 For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived -
(a) expenditure and losses ***actually incurred*** *in the production of the income, provided such expenditure and losses are not of a capital nature…*

Tax considerations

Allowance for doubtful debt (s 11(j))

Edgars Stores Ltd v CIR

Nasionale Pers Bpk v KBI

CIR v Golden Dumps (Pty) Ltd

C:SARS v Labat

Future expenditure on contracts

(s 24C)

Tax considerations

Accounting focus points touching on liabilities

Focusing on the IFRS for SMEs *(not yet adjusted for changes to CF)*

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- ✓ *What is a liability in terms of 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 the entity has no *realistic* alternative but to <u>settle</u> the obligation

- ✓ There are **two types** of present obligations dealt with in accounting
  - ❖ **Legal present obligations**
    - ➢ Binding contract/agreement
    - ➢ Statutory requirements (laws/acts)
  - ❖ **Constructive present obligations** *(often overlooked)*
    - ➢ Derives from an entity's actions/behaviours that <u>create expectations</u> in others
    - ➢ **ACTION** → **REACTION**
    - ➢ Restructuring provisions (interesting)

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Case study 1

Uncertainty surrounding pending court cases

On 22 February 2021, a customer of ABC (Pty) Ltd, Mr Jones, slipped on a wet floor and broke his leg.

On 15 March 2021, 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 2021, 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 2021, at which time the legal claim was still unresolved.

Timeline:

22 Feb	28 Feb	15 Mar	20 Mar	30 Apr
Accident	Year-end	Jones' claim	ABC Counterclaim	AFS authorised for issue

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Case study 1 – application (decision-tree)

Uncertainty surrounding pending court cases

Does a present obligation exist?

Yes, it does

Apply recognition criteria

Probable that EB will flow out?
Amount can be reliably measured?

Both yes?

Recognise liability/ provision

One/both not yes?

Disclose CL, or leave

No, it does not

Disclose CL, or leave

Uncertain…??

Does a "deemed" P/O exist? I.e., is it probable?

No

Yes

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Case study 1 – application

Uncertainty surrounding pending court cases

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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 2021, 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 2021). The addressed uncertainty relates to the amount of the claim.

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Case study 1 – application

Uncertainty surrounding pending court cases

What about the counterclaim?

Represents an **asset** to ABC (Pty) Ltd, and is therefore not dealt with in terms of Section 21 of IFRS for SME's…
Normally, assets are recognised when they meet the recognition criteria:

- **Probable** that future economic benefits will flow to the entity; and
- The amount can be **measured/estimated reliably**

HOWEVER: Assets arising out of **uncertainty** (i.e. contingent assets), can only be recognised (i.e. become assets) when it is VIRTUALLY certain that future economic benefits will flow to the entity (e.g. when an insurance company acknowledges a claim and states that it intends to settle, or when prior case law dictates how a judge is most likely to rule in terms of a court case, etc.)

RESULT: ABC (Pty) Ltd will **disclose** the counterclaim in their financial statements **(notes)** at 28 February 2021, until such time that payment of their claim becomes virtually certain, at which stage a debtor will be recognised

Prudence

Case study 2

Existence of laws and regulations

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 2021, 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 2021.

The financial statements were authorised for issue on 30 April 2021.

__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 2021__?

Case study 2 – application

Existence of laws and regulations

The "avoidance test" – the crux of present obligation

S21: Only those obligations that exist INDEPENDENTLY from the future actions of an entity, may be recognised 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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Case study 2 – application

Existence of laws and regulations

At financial reporting date 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 that causes the pollution
X (Pty) Ltd can close their business completely (not the intention, but possible)

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 that causes the pollution, before getting fined
X (Pty) Ltd can close their business completely (not the intention, but possible)

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

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, and also consider:

- Prejudicial disclosure?
- Non-compliance with legislation is an audit issue?

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Case study 3

Performance obligations – successfully used in IFRS 15

A client purchases a ticket for R2 000 from SA Airline Company (SAAC) on 21 August 2021 to fly from OR Tambo International Airport to Cape Town International Airport, on 22 December 2021. 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 by SAAC.

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?

Case study 3 – application

Performance obligations

Focus is not on revenue, but rather on <u>liabilities</u> (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):

- <u>Step 1:</u> Identify the contract that will generate the revenue
- <u>Step 2:</u> Determine the relevant underlying **performance obligations** in the contract
- <u>Step 3:</u> Determine the contract price
- <u>Step 4:</u> Assign the contract price to each performance obligation, based on stand-alone prices
- <u>Step 5:</u> As the performance obligation is extinguished, the revenue is recognised (over time/at a point)

Case study 3 – application

Performance obligations

When the ticket is **sold**, SAAC has **performance obligations** to:

- Fly the customer to Cape Town from Johannesburg on 22 December 2021. 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 2021 (date of sale of ticket):

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

22 December 2021 (date of flight):

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

Three tiers of liabilities

Strongest to weakest

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

Provisions

The "contentious" liability

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

Recognised only when:

- Entity has a past **obligation** at 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"!

Case study 4

Provisions

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?

Case study 4 – application

Provisions

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")

Case study 4 – application

Provisions

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

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

Case study 4 – application

Provisions

If assumed that A (Pty) Ltd is a **private company** that is owner-managed with a P.I. score 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?

1. 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

2. 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)

3. Should such a liability be a provision, or an outright liability? Where is the uncertainty?

4. 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?

5. Some have even argued that the provision is recognised based on the principle of an onerous contract ☺

Case study 5

Onerous contracts

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 2021 (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 2021?
  - *Assume a nominal post-tax discount rate of 7.2% per annum*

Case study 5 – application

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 (= shortfall).

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 S21 and a liability exists which is recognised.

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.

Case study 5 – application

Onerous contracts

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

Case study 5 – application

Onerous contracts

Journal entries at 28 February 2021		
Dr Operating lease expense (P/L)	R619 825 ☹	
Cr Provision for onerous contract (F/P)		R619 825
Journal entries at 28 February 2022 (assume building is sub-leased)		
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

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 expected disposal of assets = excluded from 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 virtually certain to occur
  - Amount recognised for reimbursement is limited to amount of provision
  - SoFP: Asset (once recognised) 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)*

Case study 6 – self-study

Capitalisation of the debit of a provision, to the cost of an asset

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 of use, 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 entry 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**

Case study 6 – self-study

Capitalisation of the debit of a provision, to the cost of an asset

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

Case study 7 – self-study

Provision for warranty – complex calculation (measurement)

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?

Case study 7 – self-study

Provision for warranty – complex calculation (measurement)

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?

Case study 7 – self-study

Provision for warranty – complex calculation (measurement)

In 2021, goods are sold for R1 million (excluding VAT). Experience indicates that:

- 90% of products sold require no warranty repairs;
- 6% of products sold require minor repairs costing 30% of the sale price; and
- 4% of products sold require major repairs or replacement costing 70% of sale price.

Consequently, estimated warranty costs are:

R1m × 90% × R0 = R-
R1m × 6% × 30% = R18 000
R1m × 4% × 70% = R28 000
Total = R46 000

But when do these costs take place?

Case study 7 – self-study

Provision for warranty – complex calculation (measurement)

The expenditures for warranty repairs and replacements for products sold in 2021 are expected to be made 60% in 2022, 30% in 2023 and 10% in 2024, 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).

Case study 7 – self-study

Provision for warranty – complex calculation (measurement)

Calculation of the present value, at the end of 2021, of the estimated cash flows related to the warranties for products sold in 2021 is performed as follows:

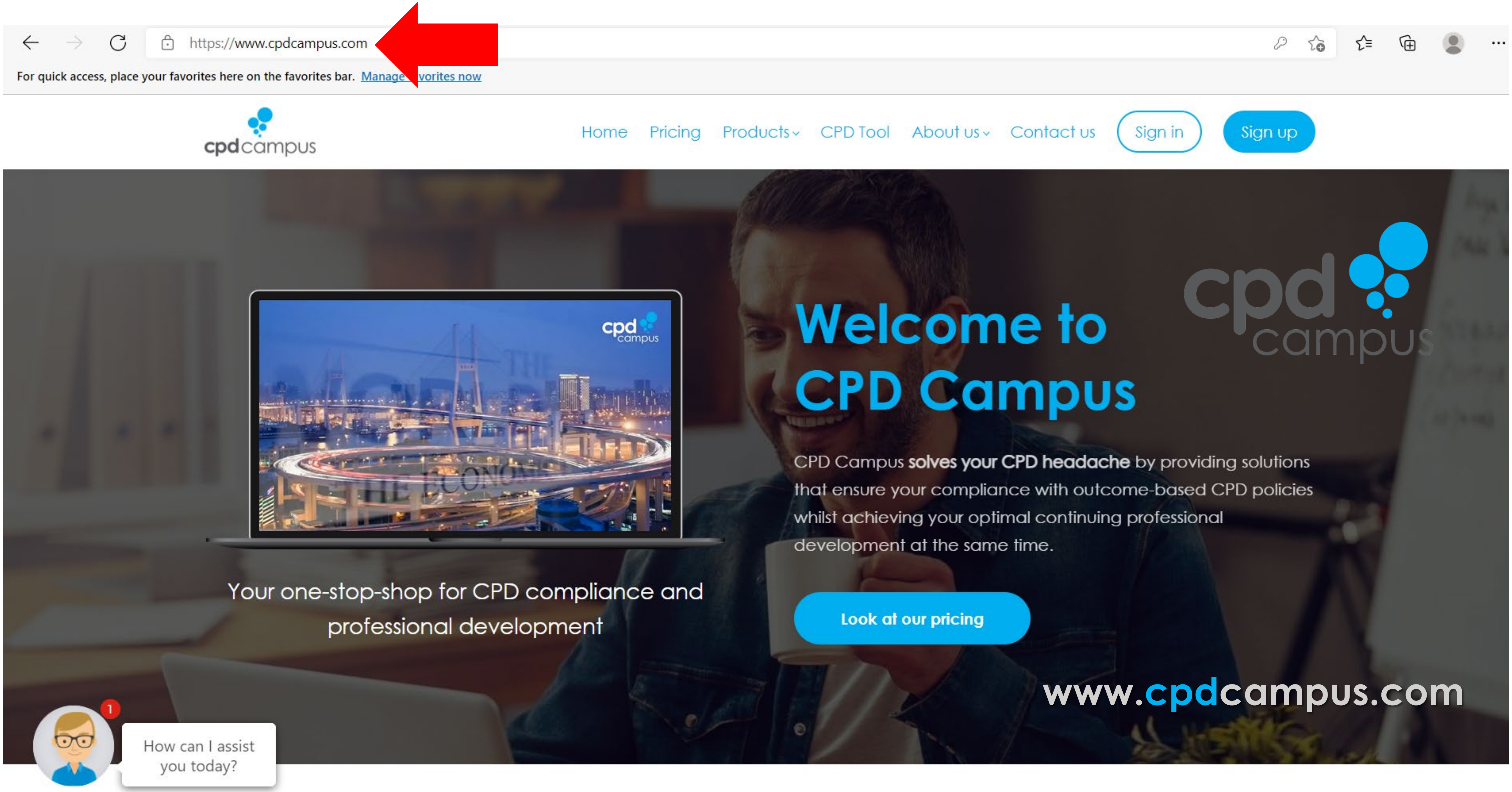
Year	Expected cash payments (R)	Discount rate	Discount factor	Present value (R)
1	60% × R46 000 = R27,600	6%	0.9434 (6% for 1 year)	R26 038
2	30% × R46 000 = R13,800	7%	0.8734 (7% for 2 years)	R12 053
3	10% × R46 000 = R4,600	7%	0.8163 (7% for 3 years)	R3 755
				Total R41 846

The entity will recognise a warranty obligation of R41 846 at the end of 2021 for products sold in 2021.

Measurement of provisions

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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