COLLEGE OF ACCOUNTING

FINANCIAL REPORTING | BASIC

Video Transcription: What are Liabilities - According to IAS37?

UCT College of Accounting

Hi, my name is Giselle and I am from UCT. Today we are going to be talking about one of the elements of the accounting equation, liabilities. But what exactly does it mean when a company recognises a liability on its Statement of Financial Position? You might already have a basic understanding of an accrual where a company receives goods or services but hasn't paid for them yet, and then recognizses a liability on the Statement of Financial Position. Even if a company hasn't received an invoice from the supplier, the obligation to pay as a result of a past event still exists, and the liability in related expenditure needs to be recognised. Receiving those goods or services creates the obligation and we usually use adjustments or month-end or year-end accruals to recognise these amounts.

If a liability has been recognised, all of the following must apply: there must be a present obligation arising from a past event and there is going to be an outflow of economic benefits or resources. So three things: present obligation, past event and outflow of economic benefits or resources. Let's discuss the first two.

What exactly is a present obligation? Well, if it is a present obligation it means it existed at year end. The obligation itself might be legal or constructive. If a company earns profits that they pay tax on then earning those profits creates the legal obligation to pay that tax. Constructive obligations are a little bit more subjective, they usually arise from past practice or announcements that a company makes – anything that realistically creates an expectation in the minds of the potential receiver of those economic benefits. Think of a company that pays out year-end holiday bonuses to its staff. Without actually saying anything, by paying out those bonuses in the past they create an expectation in the minds of their employees that they will again receive a bonus in the following year. The past practice of always paying out these bonuses creates the expectation and in turn creates the obligation.

Now what about that past event? You might have heard the past event being referred to as the obligating event. This is referring to the past event as the event, which created that obligation we just spoke about.

Think about a company that installs a new computer system and then intends to send its employees on a training course to learn how to use the new computer system. What is the past event that gives rise to an obligation to pay for training here? Is it deciding to purchase this computer system? Is it actually purchasing the computer system or maybe installing it? Or is it the employees completing their training? Let me ask this slightly differently. Could the company get out of paying for training costs after any of those events? After most of the events such as deciding to purchase the computer system or the way to installing it, the company is not required to pay for training costs. Only once the employees in fact have completed the training would the past event arise at all the other points, the cost could still be avoided. So our three things: present obligation, past event and outflow of economic benefits, that's a liability.

If you have borrowed cash then you have an obligation to repay it, usually with interest. In this case the liability is referred to as a financial liability. If you have received goods or services, which you haven't paid for yet then that is a liability, commonly referred to as accounts payable or a year-end accrual.

But don't forget, that to recognise a liability, it also needs to meet the recognition criteria, which looks specifically at the context of a situation, assessing whether the outflow of those economic benefits is probable and whether the amount at which you plan to recognise your liability is reliably measured. What if you break the law by speeding? If you were caught, you have a legal obligation to pay a fine. The speeding is the past event that creates the obligation. But what if I told you there are no cameras on the road, where you were speeding, so you weren't caught breaking the law? You have still broken the law and there is still a present obligation to pay the fine. But if no one caught you then it is not probable that you have to pay the fine then, is it? So in that case, the recognition criteria is not met and you would not recognise the liability. Just as well, imagine how difficult it would be to estimate how many times you have driven over the speed limit.

When assessing whether we can reliably measure the liability, a reasonable estimate needs to be made. Estimates are normal, it is okay to make an estimate and not know the amount exactly. But if you are uncertain about the estimate that you are making, we give the liability a special name and call it a provision. When we call something a provision, all we are saying is that we are uncertain about either the timing or the amount of the liability. It is still a liability, though.

Think of those year-end bonuses I mentioned earlier. The company might calculate its bonus payable based on the percentage of the sales they make for the year. But if their sales have not yet occurred then the company will need to make an estimate of what they think sales will be. In that case, the amount of the bonus payable, we calculate it as a percentage of that estimate and we would then call that liability provision because we are uncertain of the amount of that particular liability. Remember, we need to consider the needs of our external users and if we are uncertain about either the amount or timing of a particular liability then we need to make that clear and call that liability, a provision.

Now, what happens when you have a liability that does not meet the recognition criteria? You can't recognise it as a liability – get it? As it does not meet the recognition criteria, it is not recognised. But if it is relevant information to your external users, then we should still disclose that information. We do this by disclosing what is called a contingent liability. This is not recognised on the face of the Statement of Financial Position, it can't be as it has not met the recognition criteria for a liability but it can be disclosed. We merely disclose a note where we give information pertaining to the liability and what we expect is going to happen. Now, you wouldn't do this for every little thing. If there is only a remote chance of you paying that speeding fine, there were no cameras on the road, then that would not be useful information to your users and hopefully it is not material relative to the performance to your company. But alternatively, if you are involved in some kind of court case then, that might be useful information to your users. Even if you expect to win the court case and therefore the probability of outflow of economic benefits is low, it might still be a significant enough court case that you would need to disclose information about it in a contingent liability note.

A contingent liability meets the definition of a liability, which means there is a present obligation at year end. Contingent liabilities are often confused with commitments. What is common is that they are both disclosed in the notes. Contingent liabilities are potential bad news in relation to something that has already happened, whereas a commitment is a promise to do something in the future. Generally, in relation to acquiring future assets or services. Commitments are not recognised because the goods or services are received in the future and therefore there is no past event. So that's liabilities for you, there are three things to remember: present obligation, past event and outflow of future economic benefits. That's the three pillars of the definition of a liability. The recognition criteria then goes a little further by looking at the context of the situation. When the recognition criteria is not met then you will not recognise a liability. But you might still disclose it as a contingent liability if it is useful information to your users.

Then, also remember that we often use estimates and if we are uncertain about the timing or the amount of a liability, we recognise it as a provision, which is just a special name for a type of liability.

Now, do not go speeding just because you think there are not any cameras there to catch you.

Thanks for watching.