Is it a Liability or Other Income?

C.M. Wedage & W.D.N. Aruppala
chanchalawedage@gmail.com & dilini@kln.ac.lk

Introduction:

ABC (PVT) LTD is a family owned limited liability company. The principal activity of the company is rent & lease out of a modern office complex with high quality facilities. During the period the company has written back a Rs.3.1 Mn retention Payable balance as sundry income.

Discussion of the Issue

The external audit was performed for the year ended 2014/2015. During the audit period, an issue was identified where the company had a retention balance amounting to Rs. 3.1 Mn payable to a building contractor, Sanken Lanka (Pvt) Ltd, which was written back during the period as sundry income. This retention occurred on 20th November 2012 based on a contract between Sanken Lanka (Pvt) Ltd as the "Contractor" and the company as the "Employer" who executed to construct and complete a new office building. The contractor handed over the building to the company after a delayed period of 62 days. Due to this delay the company retained a sum of Rs. 3,100,000/- (Rs.50, 000/- per day) as liquidity damages for the contract amount.

Furthermore, an important point to note in the contract is that nothing was mentioned at the time of agreement regarding any delays in handing over. However, the company has recognized this retained amount as a payable balance for 2013/2014 and in the current year (2014/2015) it was written back as sundry income because Sanken Lanka (Pvt) Ltd has not requested to date for the said balance. Therefore the company has accounted the write back as follows.

Retention A/C (Payable)	Dr	3,100,000.00	
Sundry Income	Cr		3,100,000.00

(Retention Balance written back as sundry income)

Actually the company can't recognize this balance as a sundry income as per **section 06 of the "Prescription Ordinance of Immovable Property" which** mentions that **" Such action shall be brought within six years from date of breach of such partnership or deed of such written promise, contract , bargain or agreement or other written security".** Due to this fact, the company still has the legal obligation with Sanken Lanka (Pvt) Ltd because the contractor has a legal right to claim such amount within a period of six years.

When viewing the accounting impact according to Sri Lankan Accounting Standards for Small and Medium Enterprises (SLFRS for SMEs), section 2.20 of the "Concepts and Pervasive Principle" states that, the obligation may be either legal obligation or a constructive obligation. **A legal obligation is legally enforceable as a consequence of a binding contract or statutory requirement**. A constructive obligation is an obligation that derives from an entity's action when established pattern of practice, published polices or a sufficient specific current statement, the entity has indicated to other parties that it will accept particular responsibilities.

According to this standard, the entity has a present legal obligation with the constructor because there is a statutory requirement as per the provisions of the Prescription Ordinance of immovable property. Due to this, the company has to comply with the essential characteristics to recognize liabilities in financial position, according to SLFRS for SMEs Section 2.39 of recognition of liabilities. Those are

(a) The Entity has an obligation at end of the reporting period as a result of a past event.
(b) It is probable that the entity will be required to transfer resources embodying economic benefits in settlements and
(c) The settlements amount can be measured reliably.

So according to the scenario the entity has an obligation to report at the end of the reporting period because as per the "Provision of prescription Ordinance" company still has the legal obligation with the contractor because the contractor has a legal right to claim such amount within a period of six years. And also there is probability of economic out flow to the company within the obligated period and also the amount of liability can be measured reliably.

Implication of Issue

Due to this error the company's statement of financial position is shown an inaccurate picture on the reporting date because the amount payable to the Sanken Lanka (Pvt) Ltd was not shown under current liabilities as well as their gross profit is overstated thereby resulting in incorrect tax computation. . The ultimate effect would be an inaccurate reflection of the fair presentation of the financial statements of the company.

<u>Conclusion & Recommendation</u>

- According to this analysis, the company should consider more on the legal aspect of this amount because as per the section 06 of the "Prescription Ordinances of Immovable property" there is a legal obligation within six years.

- Therefore this retention balance should be recognized as a liability according to the section 2.39 of "concepts and pervasive principles" of SLFRS for SMEs since it has satisfied the essential characteristics of liabilities.

- We recommend that, the following reversal entry to be passed to correct this issue.

Sundry Income A/c	Dr.	3,100,000.00	
Retention A/c	Cr		3,100,000.00

(Being reversal the sundry income as a retention balance)