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The Procedure for Recognizing Liabilities in Accounting

A. Amirov
Researcher, Tashkent state university of economics

ABSTRACT

This article discusses the economic nature of liabilities and the procedure for recognizing them. The study clarified key issues related to the recognition of obligations and suggested ways to address them.

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Introduction

Accounting plays an important role in the proper functioning of the business entity. In order to effectively manage the entity's assets and accurately reflect its liabilities, these items need to be recognized in the accounting records.

Recognition is the process of including an item in the balance sheet or statement of financial performance that meets the definition of an item in the financial statements and meets the recognition criteria.

In accordance with the Conceptual Framework for the Preparation and Presentation of Financial Statements, liabilities are recognized when the following two conditions are met and may be reflected in the balance sheet:

“Economic assets are likely to be disposed of in the future;

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the recognition value of the liability can be measured reliably. ”

This view is shared by a group of economists, who are also "recognized when the value of liabilities is reliably estimated and leads to a reduction in future economic benefits."

However, as Daniel Gotze points out, “the existence of ambiguity in obligations creates difficulties in recognizing it as a conditional obligation or a measured obligation”.

Other economists have concluded that “in recognizing liabilities, special attention should be paid to their differences from the elements of private capital”.

Economists also say that "the uncertainty of the liabilities being measured makes it difficult to recognize and reflect them in the financial statements."

The basic principles of accounting should be taken into account in recognizing liabilities and determining whether they can be reflected in the financial statements.

The basic principles of IFRS accounting are: continuity and the method of calculation. Continuity is an assumption that an entity will continue to operate in the near future (for 12 months). According to the accrual method, the results of transactions are recognized at the time they are incurred, not at the time of payment, and the transaction is relevant to the reporting period in which it is entered into.

In the organization of accounting and preparation of financial statements, it is also necessary to follow the basic principles outlined below.

The prudence principle states that when uncertainties exist, precautionary measures should be taken to ensure that assets and income are not overstated and liabilities and expenses are not reduced. Under this principle, an obligation is recognized only when the entity has a reasonable assurance that an event or transaction has occurred or that an impending event is occurring.

However, excessive caution is not allowed in the organization of accounting, which can lead to the emergence of hidden reserves and distraction of users from the financial statements.

According to the principle of content over form, business transactions should be recorded not only in terms of their legal form, but also in terms of their content and economic reality. Obligations are incompatible in legal and economic terms. Therefore, the obligations arising from the contracts are crucial. In the legal sense, the amount of liabilities is determined by the value specified in the contracts, and they are almost always greater than the amount of liabilities reflected in the accounting records. The point is that the obligations arising from the concluded contracts are reflected in the accounting from the moment of their execution. So, let's assume that the management of enterprise "A" has entered into an agreement with the management of enterprise "B" for the supply of materials of a certain range and value during the year.

The full amount of liabilities specified in the contract is not related to the accounting liabilities, either in terms of assortment or value. It depends on:

1) the contract, as a rule, does not include the total amount of obligations, it specifies only the terms of delivery;
2) the application of the principle of supremacy of content over form, that is, the accounts are based on economic rather than legal. In the economic sense, an obligation is a debt that arises when the materials have already been delivered and as a result an obligation is created.

The principle of materiality implies that accounting and financial statements should reflect only the information that is important in its evaluation and decision-making by its users. It is important if the

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lack or insufficiency of data can affect decisions made by users based on financial statements. It is the importance of influencing the acceptance of financial statements by users in the form of a qualitative description, helping to evaluate, confirm or correct past, current or future events. For example, an entity recognizes vacation pay and future expenses for employees who have not taken leave in the past. Recognition of such liabilities is important and significant, meaning that costs should be recognized in the period in which they arise, not in the period in which they are incurred. If an entity does not have unused leave in prior reporting periods, there is no need to create and allocate such liabilities during the year because such information in the financial statements is irrelevant and unreasonably increases the balance sheet currency.

The principle of periodicity means that the principle of periodicity must be observed in the presentation of liabilities in accounting, the essence of which is that all business transactions and events in the accounting and financial reporting of the business entity should be separated by reporting periods. The business entity must prepare and submit financial statements for the periods (quarters, years) established by law. The results of business transactions and events in these periods are reflected in the accounting records at the time of their occurrence, not at the time of their movement or write-off. Therefore, separate accounts for liabilities are opened in the chart of accounts to reflect the liabilities to be paid in subsequent periods, one year or more. Failure to comply with this principle will have a direct impact on the financial results of the current reporting period.

If the contract in question contains a condition for advance payment by the buyer for the goods, the fact that it was concluded before the conclusion of the contract is not reflected in the accounting of the parties. Simultaneously with the transfer (receipt) of money, the seller's accounting reflects the obligation to transfer tangible assets to the buyer. However, such an obligation may be recognized as received in advance or may be recognized as a deferred income included in the liability.

By studying these two categories of accounting, one can be sure that there is a common aspect between the advances received and the income for the next period (Figure 1).

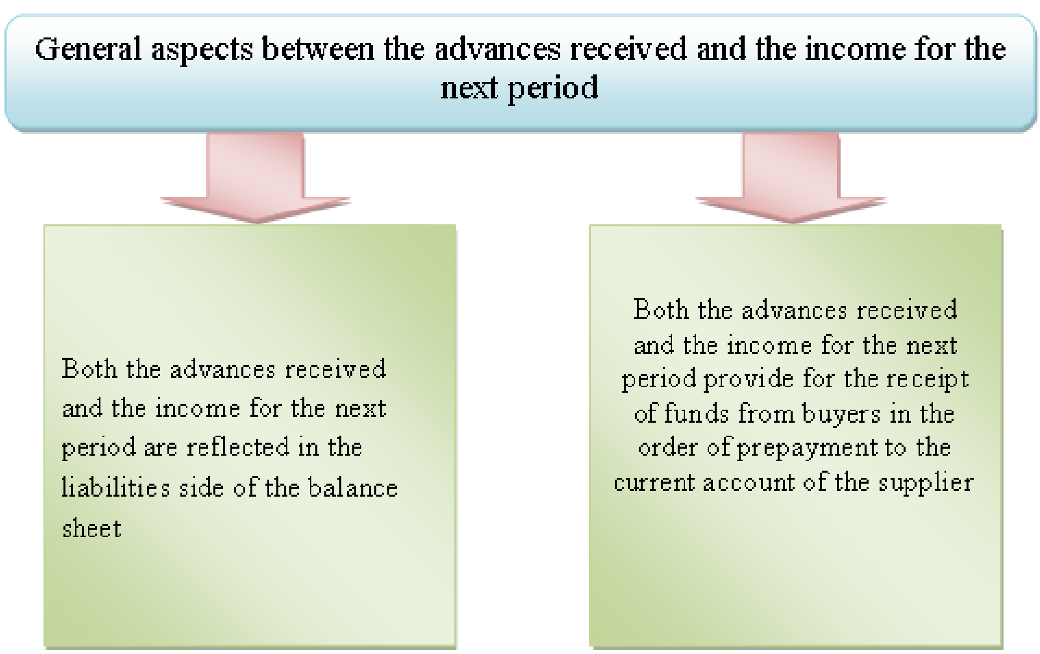

Figure 1. General aspects between the advances received and the income for the next period [1]

[1] Made by author

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As for the differences between the advances received and the income for the next period, we note the following:

First, an increase in economic benefits in the form of an inflow or increase in assets or a decrease in liabilities is recognized as income. The advances received do not meet the criteria for recognizing income, i.e., they do not provide economic benefits on their own;

Second, the main difference between the advances received and the income for the next period is that the income for the next period is divided into several periods.

Recognition of future periods 'income is primarily related to the need to adhere to the principle of conformity, i.e., the income should be commensurate with the expenses incurred. Deferred income, in particular, for the lease of fixed assets and other long-term assets (advance rent), subscriptions to newspapers, magazines, periodicals, ticket sales of transport and theater and entertainment companies, subscription fees for communication, etc. income in the form of advance payments. According to the principle of conformity, such income cannot be fully included in the current year's income because the financial statement is prepared for the year, i.e. the income must include payment for one year, the rest is recognized as accounts payable and each subsequent year the accounts payable decrease and the following year income increases.

If the liability at present does not meet the above recognition criteria, but may arise in the future for accounting purposes, such an obligation may be recognized as a contingent liability and the information about it is presented in the appendix to the financial statements. Its occurrence in the future depends on the occurrence or non-occurrence of any fact of economic life that we may regard as the basis of this obligation. This conditionality is that, based on the traditional accounting rules, these liabilities should not be reflected in the accounts in the accounts with the counterparties in the accounting report at the time of consideration. That is, there are currently no liabilities from a legal point of view, and the need to recognize them will be related to the accounting principles described above, i.e., materiality and materiality. In this context, the fact of economic life is considered significant if the information about it is important for assessing the financial condition of the enterprise. It is necessary to separate the liability to be measured from the contingent liability. Liabilities to be measured should be reflected as liabilities of unknown amount and maturity, and two types of circumstances should be identified that lead to their occurrence.

It should be noted that the obligations arise mainly in two ways:

First, the obligations may arise from the norms of legislation and other normative legal acts, court decisions, contracts;

second, liabilities may be incurred by the entity itself.

For example, the management of a business entity has decided to reduce the number of employees in a particular division, but as of the reporting date, employees have not yet been notified of future dismissals in the manner prescribed by the Labor Code. In this case, the liability assessed on the severance pay to the dismissed employees is not recognized at the reporting date. If, on the reporting date, employees were personally notified by signing a notice of future dismissal, the obligation to be assessed on the severance pay should be recognized by the dismissed employee. Thus, the decision of the management to reduce the number of employees on its own does not give rise to an obligation to be assessed. The assessed liability is recognized at the reporting date if the parties (employees) to which it relates have been notified prior to the reporting date and the entity has reasonable reason to expect it to meet its pension obligations.

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In summary, liabilities must be properly recognized in order to be reflected in the accounting records and disclosed in the financial statements. Compliance with these requirements will enable users of financial reporting to make informed decisions.

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