



Accounting news

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Proposed New EU Audit Legislation

In the previous issue of Accounting News, we focused on the proposed new EU legislation on accounting. In early December, the European Commission also presented a proposal for new audit regulation. Although the proposal relates predominantly to auditors, it also includes new obligations for audited companies. In this article, we would like to outline the key elements of the proposal.

The European Commission proposes an amendment to the existing directive on obligatory audit issued in 2006, which was incorporated into Czech legislation through the Act on Auditors in 2009. In addition, the proposal includes an entirely new provision focusing on the audit of public-interest entities. This legal initiative was preceded by extensive discussions initiated by a Green Paper issued in autumn 2010. In the Green Paper, the European Commission provided a number of creative proposals for public discussion, including the transfer of competencies for selecting an auditor to a state supervisory body or common audits, ie audits performed by two auditors or audit firms simultaneously. The collected responses to most proposals were negative and pointed to ambiguous experience with certain measures in the countries where they were applied. The European Parliament's resolution on this matter was also rather restrained. Surprisingly, the European Commission has nevertheless proposed relatively significant changes.

Professionals agree that some proposals are positive and support an increase in audit quality and the improvement of market conditions:

- Application of ISA (International Standards on Auditing) as a single set of standards for audits in the EU. Contrary to the Czech Republic, some EU member states have yet to approve ISA and keep using their own standards or modified ISA. Establishing a single standard for the EU will lead to the desired market integration and, ultimately, to the reduction of audit costs.
- Strengthening of the role played by audit committees. Certain issues of the existing audit committee regulations have not been crystal clear and for this reason, clarification is much desired, predominantly in respect of the responsibilities for selecting an auditor.

- Ban on contractual arrangements limiting the selection of an auditor. In certain circumstances, limiting conditions are established (predominantly by financing banks) relating to the selection of an auditor. This procedure should be banned in the future.

Some of the proposed measures change the structures based on the existing directive on obligatory audit. This predominantly includes the transfer of activities from a professional organisation (chamber) to a public supervisory body, including the registration and approval of auditors and quality control. Irrespective of the fact that modifications are to be made to a system that was only established a few years ago, the proposals will result in more-significant requirements for the funding of these activities from the state budget.

Most new requirements are included in the regulation of the audit of public-interest entities. This may give the impression that this issue only relates to a small number of businesses and will not impact the conditions of many audits. However, the new requirements relate not only to public-interest entities (ie predominantly companies traded on the stock exchange) but also to all of their subsidiaries and as such they will impact a large number of entities.

The most important requirement is the significant limitation of non-audit services provided by an auditor. Principally, the proposal includes imposing a ban on any other services outside of the statutory audit, which means the statutory audit of a public-interest entity here, ie the auditing of the consolidation packages of subsidiaries. As audit services outside of the scope of the statutory audit are limited to 10% of the statutory audit cost, companies may be need to use multiple auditors (eg to audit the optional financial statements under IFRS or grant accounting) because the scope of the services will exceed the proposed 10% limit. It is obvious that such a situation would result in additional complications and a necessary increase in audit costs.

Audit firms with large market shares in a single member state are now only required to provide audit services within their networks in the EU. The audit firms will thus have to purchase some professional services (such as financial instrument valuation or actuarial

calculations) while they have to date received them from their consulting team professionals. Regardless of a possible impact on quality, this is likely to result in a price increase.

In order to support the independence of auditors, the obligatory rotation of auditors is proposed. A single audit firm may perform an audit for a maximum of six years and then it should be replaced based on a tender, to which at least one small audit firm must be invited. As such, companies are required to organise regular tenders and to deal with a new auditor every few years. The experience shows that obligatory rotation complicates the course of the audit and available studies refer to the risk of a reduction in quality, particularly in the first two years following the change.

Significant changes are proposed in respect of audit reports. For public-interest entities, the report is substantially expanded and the auditor is required to provide an opinion on some other facts. To meet these conditions, the existing procedures will have to be modified and the audit reporting of subsidiaries of listed companies will have to be expanded. In addition, auditors will be required to report any identified law violation, threats to the going concern principle or possible qualified opinions to the regulator. This obligation has not been included in the EU regulation so far, but, for some types of entities, it is contained in the Czech Act on Auditors.

The scope of the proposed changes is relatively large and has spurred extensive discussion. As the proposals must be approved by the EU member states and the European Parliament, further changes may be expected. Some member states consider a number of the proposed measures useless and will strive to change them. Many regulators (including the Czech National Bank) are worried about the unpredictable impact of the changes on the market and the stability of, predominantly, the financial market. The European Parliament obviously does not accept that the European Commission failed to respect some of the Parliament's requirements. For this reason, it is too early to come to any conclusions or to prepare for some of the above-mentioned measures. However, it will be interesting to observe how the proposal will be further modified.

Closing Out 2011

This newsletter provides a high-level overview of new and revised Standards and Interpretations that are effective for December 2011 calendar year-ends and subsequent accounting periods.

Entities are, however, generally permitted to adopt new and revised Standards and Interpretations in advance of their effective dates (refer to individual Standards and Interpretations for additional details). This newsletter provides a summary of IFRSs and interpretations that an entity may elect to apply for the year ending 31 December 2011.

Where applicable, we have made reference to past Accounting News dealing with the specific Standard or Interpretation in greater detail. These past newsletters are also available at www.deloitte.cz. As always, entities should refer to the Standards and Interpretations themselves to identify all of the changes that may affect their particular circumstances.

Where a Standard or Interpretation is adopted in advance of its effective date, disclosure of that fact is generally required.

Even where there is no intention to implement a Standard or Interpretation in advance of its effective date, entities need to be aware of new Standards and Interpretations as they are issued, in order to comply with the requirement included in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to disclose in their financial statements the potential impact of Standards and Interpretations in issue but not yet effective.

We therefore recommend reviewing further newly issued amendments to standards and interpretations that will be approved by the date of the issuance of a company's financial statements. We will be providing updates on these developments on www.iasplus.com and in our Accounting News.

Finally, a word of caution regarding early adoption of Standards and Interpretations in the case of the entities that prepare financial statements according to IFRS as adopted by the European Union (EU).

As of 1 January 2012, the following documents have not yet been endorsed by the EU:

Standards

- IFRS 9 *Financial Instruments* (issued in November 2009)
- IFRS 10 *Consolidated Financial Statements* (issued in May 2011)
- IFRS 11 *Joint Arrangements* (issued in May 2011)
- IFRS 12 *Disclosures of Involvement with Other Entities* (issued in May 2011)
- IFRS 13 *Fair Value Measurement* (issued in May 2011)
- IAS 27 (2011) *Separate Financial Statements* (issued in May 2011)
- IAS 28 (2011) *Investments in Associates and Joint Ventures* (issued in May 2011)

Interpretations

- IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* (issued in October 2011)

Amendments

- Amendments to IFRS 1 *Removal of Fixed Dates for First-Time Adopters* (issued in December 2010)
- Amendments to IFRS 1 *Severe Hyperinflation* (issued in December 2010)
- Amendments to IAS 12 *Deferred Tax: Recovery of Underlying Assets – Amendments to IAS 12* (issued in December 2010)

- Amendments to IAS 1 *Presentation of Items of Other Comprehensive Income* (issued in June 2011)
- Amendments to IAS 19 *Employee Benefits* (issued in June 2011)
- Amendments to IAS 32 *Offsetting Financial Assets and Financial Liabilities* (issued in December 2011)

The endorsement status report can be found at www.iasplus.com/efrag/efrag.htm#endorse.

New and Revised Standards and Interpretations

The following tables provide a list of new and revised Standards and Interpretations in issue at December 2011 that are either effective, or available for early adoption, for 31 December 2011 calendar year-ends.

All of the newsletters referred to may be found on www.deloitte.com/cz/newsletters/accounting-news/archive

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Effective for 31 December 2011 year-ends

Amendments to Standards		Effective for annual periods beginning on or after	Accounting news
IFRS 1	IFRS 7 Short-term Disclosure Exemption	1 July 2010	<i>March 2010</i>
	IFRS 9 Short-term Exemption	1 July 2010	<i>December 2009</i>
	Three amendments ¹ to IFRS 1 – changes in accounting policies, deemed cost exemption for event-driven fair value measurements and deemed cost (rate-regulated entities)	1 January 2011	<i>June 2010</i>
IFRS 3 (2008)¹	Measurement of non-controlling interests Un-replaced and voluntary replaced share-based payment awards Transitional requirements for contingent consideration	1 July 2010	<i>June 2010</i>
IFRS 7¹	Clarifications of disclosures	1 January 2011	<i>June 2010</i>
IAS 1¹	Clarification of statement of changes in equity	1 January 2011	<i>June 2010</i>
IAS 24	Related Party Disclosures	1 January 2011	<i>November 2009</i>
IAS 27 (2008)¹	Transitional requirements for consequential amendments as a result of IAS 27 (2008)	1 July 2010	<i>June 2010</i>
IAS 32	Classification of Rights Issues	1 February 2010	<i>November 2009</i>
IAS 34¹	Significant events and transactions	1 January 2011	<i>June 2010</i>
New Interpretation			
IFRIC 19	Extinguishing financial liabilities with equity instruments	1 July 2010	<i>December 2009</i>
Amended Interpretations			
IFRIC 13¹	Fair value of award credits	1 January 2011	<i>June 2010</i>
IFRIC 14	Prepayments of a Minimum Funding Requirement	1 January 2011	<i>December 2009</i>

¹ Amended as part of Improvements to IFRSs 2010

Available for early adoption for 31 December 2011 year-ends

New and Amended Standards		Effective for annual periods beginning on or after	Accounting news
IFRS 1	Removal of Fixed Dates for First-Time Adopters	1 July 2011	<i>January 2011</i>
	Severe Hyperinflation	1 July 2011	<i>January 2011</i>
IFRS 7	Enhanced Derecognition Disclosure Requirements	1 July 2011	<i>November 2010</i>
IFRS 9	Financial Instruments: Classification and Measurement	1 January 2015	<i>December 2009</i>
	Additions to IFRS 9 for Financial Liability Accounting	1 January 2015	<i>November 2010</i>
IFRS 10	Consolidated Financial Statements	1 January 2013	<i>August 2011</i>
IFRS 11	Joint Arrangements	1 January 2013	<i>August 2011</i>
IFRS 12	Disclosure of Interests in Other Entities	1 January 2013	<i>August 2011</i>
IAS 27 (2011)	Separate Financial Statements	1 January 2013	<i>August 2011</i>
IAS 28 (2011)	Investments in Associates and Joint ventures	1 January 2013	<i>August 2011</i>
IFRS 13	Fair Value Measurement	1 January 2013	<i>September 2011</i>
IAS 1 (2011)	Amendments to IAS 1	1 July 2012	<i>August 2011</i>
IAS 12	Deferred Tax: Recovery of Underlying Assets	1 January 2012	<i>January 2011</i>
IAS 19	Amendments to IAS 19	1 January 2013	<i>August 2011</i>
New Interpretation			
IFRIC 20	Stripping Costs in the Production Phase of a Surface Mine	1 January 2013	<i>November 2010</i>

New Amendments to IAS 32 Financial Instruments: Presentation and IFRS 7 Financial Instruments: Disclosures

In December 2011, the International Accounting Standards Board (IASB) amended the accounting requirements and disclosures related to offsetting financial assets and financial liabilities by issuing amendments to IAS 32 *Financial Instruments: Presentation* and IFRS 7 *Financial Instruments: Disclosures*.

Amended disclosures

The amendments to IFRS 7 require an entity to disclose information about rights of offset and related arrangements (such as collateral posting requirements) for financial instruments under an enforceable master netting agreement or similar arrangement.

Clarification of IAS 32

IASB has amended IAS 32 to clarify the meaning of:

- 'currently has a legally enforceable right of set-off' and
- 'simultaneous realisation and settlement'.

Meaning of 'currently has a legally enforceable right of set-off'

The amendments clarify that to result in offset of a financial asset and a financial liability, a right to set-off must be available today rather than being contingent on a future event and must be exercisable by any of the counterparties, both in the normal course of business and in the event of default, insolvency or bankruptcy. Also, the amendments clarify that the determination of whether the right meets the legally enforceable criterion will depend on both the contractual terms entered into between the counterparties as well as the law governing the contract and the bankruptcy process in the event of bankruptcy or insolvency.

Observation

Entities may not have considered events of default, insolvency or bankruptcy in their assessment of the offsetting rules or may have only considered the counterparty rather than all parties to the arrangement. Therefore, entities may need to reconsider their existing arrangements to determine whether items currently being offset would qualify for such a presentation under the amended guidance. This reconsideration may include new or revised legal opinions.

Meaning of 'simultaneous realisation and settlement'

The amendments provide clarification on which settlement processes would meet the requirement for offsetting that an entity has 'the intention to settle a financial asset and a financial liability net or simultaneously'. The realisation of a financial asset and settlement of a financial liability is simultaneous if the settlements occur 'at the same moment'. However, gross settlement that does not occur simultaneously may also meet the principle and criteria for offsetting if a single settlement process results in cash flows being equivalent to a single net amount. Specifically, a gross settlement system would meet the criteria for net settlement if it has all of the following characteristics:

- financial assets and financial liabilities that meet the right of set-off criterion are submitted for processing at exactly the same point;
- once the financial assets and liabilities are submitted for processing, the settlement instructions cannot be cancelled or altered;
- there is no potential for the cash flows arising from the assets and liabilities to change once they have been submitted for processing unless the processing fails;

- if the processing of one asset or liability that is offset against another fails, then the processing of the related security used as collateral will also fail (and vice versa);
- any transactions that fail will be re-entered for processing until they are settled;
- settlement of the amount due and payable is carried out through the same settlement institution (for example, delivery versus payment or the same depository account); and
- there exists an intraday credit facility that will provide sufficient overdraft or other intraday credit at the settlement date for each of the parties, and there is a high likelihood that the intraday credit facility would be honoured if called upon.

Effective date and transition

The amended offsetting disclosures are required for annual periods beginning on or after 1 January 2013 and interim periods within those annual periods. The disclosures should also be provided retrospectively for all comparative periods. However, the clarifying amendments to IAS 32 are not effective until annual periods beginning on or after 1 January 2014, also with retrospective application required.

New IFRS Publication by Deloitte

IFRS model Financial Statements for the year ended 31 December 2011 in Czech

The Czech version of the IFRS model consolidated financial statements is available on www.deloitte.cz. The model financial statements are intended to illustrate the presentation and disclosure requirements of IFRSs. They also contain additional disclosures that are considered to be best practice, particularly where such disclosures are included in illustrative examples provided with a specific Standard.

The model financial statements **illustrate** the impact of a number of new and revised Standards and Interpretations that are mandatorily effective on 1 January 2011 - Amendments to IAS 1 *Presentation of Financial Statements* and revised version of IAS 24 *Related Party Disclosures* (affecting presentation and disclosure only) and Amendments to IFRS 3 *Business Combinations* (affecting the reported financial performance and/or financial position).

The model financial statements **do not illustrate** the impact of early adoption of the following new Standards that are effective for annual periods beginning on or after 1 January 2013 and have not yet been endorsed by the EU:

- IFRS 9 *Financial Instruments* (effective for annual periods beginning on or after 1 January 2015),
- IFRS 10 *Consolidated Financial Statements*,
- IFRS 11 *Joint Arrangements*,
- IFRS 12 *Disclosure of Interests in Other Entities*, and
- IFRS 13 *Fair Value Measurement*.

IASB defers the mandatory effective date of IFRS 9 and adds disclosure requirements

On 16 December 2011, the International Accounting Standards Board (IASB) issued *Mandatory Effective Date of IFRS 9 and Transition Disclosures* ('the amendments'), deferring the mandatory effective date of both the 2009 and 2010 versions of IFRS 9 *Financial Instruments* to annual periods beginning on or after **1 January 2015**. Prior to the amendments, application of IFRS 9 was mandatory for annual periods beginning on or after 1 January 2013. The amendments continue to permit early application.

The Board is deferring the mandatory effective date of IFRS 9 as a result of recent changes in the expected timing of completion of the remaining phases of the financial instruments project.

Transition to IFRS 9

The amendments modify the requirements for transition from IAS 39 *Financial Instruments: Recognition and Measurement* to IFRS 9. These requirements now differ depending on the entity's date of adoption.

An entity that adopts IFRS 9 for reporting periods:

- beginning before 1 January 2012 is not required to restate prior periods and is not required to provide the modified disclosures;
- beginning from 1 January 2012 until 31 December 2012 must elect either to provide the modified disclosures or to restate prior periods;
- beginning 1 January 2013 or thereafter shall provide the modified disclosures but need not restate prior periods.

Modified disclosures

The amendments modify IFRS 7 *Financial Instruments: Disclosures* to add requirements in the reporting period containing the date of initial application of IFRS 9.

Selected Issues from Inventory Classification

The year 2011 is over and most production or sale firms have completed their stock-takes. Valuation, which we discussed in the December issue of our Accounting News, is a frequent topic relating to inventory. However, valuation considerations may be preceded by doubts as to whether a given asset is an asset and whether it may be classified as inventory. For this reason, we have selected several examples where the answer to this question is no under US legislation. Frequent errors include the classification of spare parts as inventory; the approach of Czech regulations to this issue is absolutely different from US GAAP or IFRS. Before providing you with specific examples, let us remind you what items are considered inventory under US GAAP and what standards relate to inventory.

US GAAP deals with Inventory in FASB Accounting standard codification (ASC) 330 – Inventory.

Items of tangible property that have any of the following characteristics are classified as inventory based on ASC 330-10-20:

- a. Items held for sale in the ordinary course of business;
- b. Items in the process of production for such sale; and
- c. Items to be currently consumed in the production of goods or services to be available for sale.

The term “inventory” embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies). This definition of inventory excludes long-term assets subject to depreciation accounting, or goods that, when put into use, will be so classified. The fact that a depreciable asset is retired from regular use and held for sale does not indicate that the item should be classified as part of the inventory. Raw materials and supplies purchased for production

may be used or consumed for the construction of long-term assets or other purposes not related to production, but the fact that inventory items representing a small portion of the total may not be absorbed ultimately in the production process does not require separate classification. By trade practice, operating materials and supplies of certain types of entities such as oil producers are usually treated as inventory.

Should be spare parts classified as inventory?

It is a common practice that companies maintain spare parts in order to replace broken parts on their production equipment. Should the company account for these spare parts as inventory?

Spare parts are not held for sale, nor are they in the process of production for such sales, nor will they be currently consumed in the production. Thus, spare parts do not meet the definition of inventory in ASC 330-10-20. Therefore, the company should classify the parts as other current assets if it is probable that the spare parts will be used within the company's operating cycle. If the spare parts will not be used within the company's operating cycle, the parts should be classified as non-current assets in the balance sheet, and amortised over their estimated useful life.

Should spare parts held for maintenance contracts be classified as inventory?

In connection with a maintenance contract with a customer, a company may have spare parts on hand. The company uses the spare parts to replace broken parts of the customer's machinery. The company only uses the spare parts for the maintenance contracts. How should the company account for the spare parts?

The company should account for the spare parts as inventory because they met the definition of Inventory as provided in ASC 330-10-20.

Should equipment that may be either sold or rented be classified as inventory?

In cases where a company manufactures equipment which may be sold or rented to customers using operating leases, or when a company may sell previously-rented equipment to customers, should the company record this equipment as inventory?

It is obvious that equipment that is produced for sale should be included in inventory. However, once the equipment is leased to a customer, it should be reclassified out of inventory. Per ASC 840-20-45-2 and ASC 840-20-35-3, the lessor should account for assets rented under operating leases with or near property, plant, and equipment in the balance sheet and should depreciate these assets based on the lessor's normal depreciation policy.

When previously-leased equipment is sold later as used equipment, the company should record the sales proceeds in revenue and record the cost of sales equal to the net book value of the equipment at the time of sale.

Can inventory be included in non-current assets?

In practice, situations may occur when a company has a significant amount of inventory on hand that will probably not be sold within the company's one-year operating cycle, based on historical monthly sales. Should the inventory not expected to be sold within one year be accounted for as a non-current asset within the balance sheet?

Yes; ASC 310-10-45-9 states that, for accounting purposes, the term “current assets” is used to designate cash and other assets or resources commonly identified as those that are reasonably expected to be realised in cash or sold or consumed during the normal operating cycle of the business.

ASC 210-10-45-3 states that a one-year time period should be used to define current assets if there clearly is no defined operating cycle.

Additionally, AICPA Technical Practice Aids, TIS Section 2140.13, "Classification of Slow-Moving Inventory", states that the amount of slow-moving inventory not reasonably expected to be realized in cash during the client's normal operating cycle should be classified as a long-term asset in the company's classified balance sheet. Inventory in excess of the amounts expected to be sold within the company's operating cycle should be accounted for as non-current assets.

Consignment inventory classification

Consignment inventory transactions can take different forms. In many cases, consignment inventory represents inventory received by a dealer (consignee) from a manufacturer (consignor) for the purpose of selling the inventory to customers. The dealer returns any unsold inventory to the manufacturer. The manufacturer maintains title to and risk of ownership of the inventory until the inventory is sold to the end customer. In other cases, the consignee is a manufacturer that receives inventory from a supplier (consignor). The manufacturer can return the inventory to the supplier before the inventory is consumed in the manufacturer's production; however, once the inventory is consumed, the title and risk of ownership transfer to the manufacturer. Therefore, the consignee does not record inventory in its balance sheet for the amount of consignment inventory held until the inventory has been consumed in the consignee's production.

For example, a retailer enters into an agreement with a supplier to purchase inventory to sell to customers. Under the agreement, the retailer receives the inventory and has the right to return the inventory at any time during the contract period, but must either return or purchase any unsold inventory at the end of the contract period. Is this agreement a consignment inventory arrangement?

If the retailer assumes title to and risk of ownership of the inventory upon receipt, the agreement would not generally be considered a consignment arrangement. Therefore, the retailer would record the inventory as of the date of inventory receipt. If the supplier retains title to and maintains risk of ownership of the inventory, the agreement would generally be considered a consignment arrangement and the supplier would continue to record the inventory until both title and risk of ownership transfer to the retailer (eg, when the retailer sells the inventory to a customer).

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