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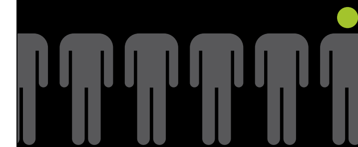

Keep your head when all around are losing theirs

Accounting news

Czech Accounting, IFRS and US GAAP

January 2011, Deloitte Czech Republic

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Intangible Fixed Assets

Intangible fixed assets are defined in Czech legislation predominantly by Act No. 563/1991 Coll., on Accounting, Regulation No. 500/2002 Coll., and Czech Accounting Standard No. 13. Although it may seem that the accounting legislation on intangible fixed assets has not undergone any changes, this is not the case. The changes adopted for the 2011 accounting period introduce new aspects to accounting for and recognising intangible assets. More specifically, these changes enable a variable approach, predominantly as a result of the new possibility to use IFRS rules starting in 2011.

As we informed you previously, the new amendment to the Accounting Act allows IFRS rules to be used for accounting and statutory purposes by companies preparing a consolidation package that is prepared under IFRS or for companies that are part of a "local" consolidation group, in cases where the parent company decides to use IFRS. Thus, the range of companies that may use IFRS for primary accounting has been expanded significantly.

Definition of Intangible Assets

One of the drawbacks of Czech accounting legislation is the fact that it does not contain a definition of intangible fixed assets. Principal items of intangible assets include start-up costs, research and development, software, valuable rights (eg intellectual property) and goodwill with useful life exceeding one year, and valuation thresholds determined by the entity, except for goodwill. In addition, intangible assets include improvements exceeding the amount determined by the Income Taxes Act provided that conditions listed in Section 6 of Regulation No. 500/2002 are met.

In addition, the Regulation provides a negative definition of intangible fixed assets. It states that intangible fixed assets predominantly exclude expert opinions, market research, development plans, proposals of promotional and advertising events, quality system certifications, and software for technology management or for equipment that does not work without such software. Furthermore, an entity may decide that intangible fixed assets also exclude technical audits and energy audits, forest working plans, and river basin plans.

When applying IFRS accounting for statutory purposes, the definition of intangible assets is specific according to IAS 38, as it involves compliance with the following criteria:

- They must be separately identifiable assets without physical substance.
- They must be controlled by the entity as a result of past events.

Other criteria include the fact that future economic benefits from the intangible assets are expected to flow to the entity and the costs of the asset can be measured reliably. Under IFRS, it is necessary to assess whether the improvements comply with the listed criteria for intangible assets. Unlike Czech accounting legislation, IFRS does not include any relation to the value of acquired assets (eg the CZK 40 thousand threshold does not play any role in recognising improvements as intangible fixed assets). In addition, start-up costs are recognised directly in expenses according to IFRS. In accordance with Czech legislation, such costs are amortised over 60 months.

In addition, the definition of research and development is rather problematic in Czech practice. According to Section 6 (3) of the Regulation, research and development include internally produced items for trading or acquired from other parties. Under IAS 38, the definition of this category is more precise. Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

While research cannot be capitalised, development is recognised as an intangible asset when it complies with the following criteria: technical feasibility; intention to complete the intangible asset and use or sell it; the ability of the entity to use or sell the intangible asset; the possibility of proving the benefits of an intangible asset; availability of adequate technical, financial, and other resources to complete the development of the intangible asset; and the ability to reliably measure the expenditure attributable to the intangible asset during its development. In Czech practice, development is often capitalised through Complex deferred expenses.

Valuation of Intangible Assets

With respect to the valuation of intangible assets, the Accounting Act stipulates that intangible assets, except for receivables and internally generated intangible assets, are valued at cost. Internally generated intangible assets are valued at internal cost. According to Section 25 (4) (d) of the Accounting Act, internal costs include all direct costs and indirect costs directly relating to internally generated intangible and tangible fixed assets (production costs), or indirect administrative costs, if the internal production of assets is of a long-term nature (exceeding one reporting period).

Subsequently, entities are obliged to prepare a depreciation plan based on which they will depreciate assets when used. IFRS accounting enables two alternative treatments. An entity may depreciate an intangible asset from the original cost, or the revaluation model can be used. In such case, intangible assets are remeasured to fair value and, subsequently, depreciation is recognised from the remeasured amount. Applying the revaluation model is conditioned by the existence of an active market, which is unusual for intangible assets in practice. Under IAS 38, the depreciable amount is the cost of an asset, or other amount substituted for cost less the residual value of the asset. The residual value of an intangible asset in practice is usually zero. In this respect, we see no significant changes relating to the potential transition to IFRS accounting for statutory purposes.

Differences between Czech accounting legislation and IFRS arise with respect to the indefinite useful life of an intangible asset. Under IFRS, intangible assets are not amortised if there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the. As an example of intangible assets with indefinite useful lives we can note licences, provided that they do not relate

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to definite useful lives (eg licences contractually limited in time) and it is anticipated that they will contribute to generating cash flow for an entity over an indefinite period of time, as they do not relate to technological changes that might limit their useful lives. Czech accounting legislation does not use indefinite useful life; intangible assets must be amortised. IFRS subsequently requires an annual identification of the "recoverable amount" of intangible assets with indefinite useful lives according to IAS 36, even without the existence of indicators of asset impairment. The recoverable amount is the higher of an asset's fair value less the costs to sale and its value in use (present value). On the other hand, Czech legislation includes a certain analogy in the form of a provision against fixed assets. In this respect, Czech accounting legislation, however, does not provide specific guidance on assessing the impairment of intangible assets.

The details referred to above do not provide a complete list of all the rules for accounting and recognising intangible fixed assets or the differences between Czech legislation and IFRS; however, we believe that they will serve for a better understanding of the principal aspects that should be considered in accounting practice.

Specific rules apply to accounting for goodwill, which is accounted for separately from intangible assets under IFRS. Individual attention should also be paid to emission allowances. For this reason, we will cover emission allowances in a subsequent issue of the Accounting News.

Closing Out 2010

This newsletter provides a high-level overview of new and revised Standards and Interpretations that are effective for December 2010 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 2010.

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 2011, the following documents have not yet been endorsed by the EU:

Standards

- IFRS 9 *Financial Instruments* (issued in November 2009)

Amendments

- *Improvements to IFRSs* (Issued in May 2010)
- Amendments to IFRS 7 *Financial Instruments: Disclosures* (issued in October 2010)
- 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 IFRS 12 *Deferred Tax: Recovery of Underlying Assets – Amendments to IAS 12* (issued in December 2010)

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

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New and Revised Standards and Interpretations

The following tables provide a list of new and revised Standards and Interpretations in issue at December 2010 that are either effective, or available for early adoption, for 31 December 2010 calendar year-ends.

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

Effective for 31 December 2010 year-ends

Amendments and Revised Standards		Effective for annual periods beginning on or after	Accounting news
IFRS 1	Revisions to IFRS 1 on First-Time Adoption of IFRSs	1 July 2009	December 2008
	Additional exemptions for First-Time Adopters	1 January 2010	September 2010
IFRS 2	Group Cash-settled Share based Payments	1 January 2010	April 2010
IFRS 3 (2008) and IAS 27 (2008)	Business Combinations; Consolidated and Separate Financial Statements	1 July 2009	February 2008
IAS 39	Eligible Hedged Items	1 July 2009	September 2008
Various	Improvements to IFRSs	1 July 2009 or 1 January 2010	July 2009
New interpretations			
IFRIC 17	Distributions of Non-cash Assets to Owners	1 July 2009	December 2008
IFRIC 18	Transfers of Assets from Customers	Transfers received on or after 1 July 2009	February 2009

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Available for early adoption for 31 December 2010 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	March 2010
	IFRS 9 Short-term Exemption	1 July 2010	December 2009
	Three amendments1 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	June 2010
	Removal of Fixed Dates for First-Time Adopters	1 July 2011	January 2011
	Severe Hyperinflation	1 July 2011	January 2011
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	June 2010
IFRS 7	Clarifications of disclosures[1]	1 January 2011	June 2010
	Enhanced Derecognition Disclosure Requirements	1 July 2011	November 2010
IFRS 9	Financial Instruments: Classification and Measurement	1 January 2013	December 2009
	Additions to IFRS 9 for Financial Liability Accounting	1 January 2013	November 2010
IAS 1[1]	Clarification of statement of changes in equity	1 January 2011	June 2010
IAS 12	Deferred Tax: Recovery of Underlying Assets	1 January 2012	January 2011
IAS 24	Related Party Disclosures	1 January 2011	November 2009
IAS 27 (2008)[1]	Transitional requirements for consequential amendments as a result of IAS 27 (2008)	1 July 2010	June 2010
IAS 32	Classification of Rights Issues	1 February 2010	November 2009
IAS 34[1]	Significant events and transactions	1 January 2011	June 2010
New interpretation			
IFRIC 19	Extinguishing financial liabilities with equity instruments	1 July 2010	December 2009
Amended Interpretations			
IFRIC 13[1]	Fair value of award credits	1 January 2011	June 2010
IFRIC 14	Prepayments of a Minimum Funding Requirement	1 January 2011	December 2009

[1] *Amended as part of Improvements to IFRSs 2010*

New IFRS Publication by Deloitte

IFRS model Financial Statements for the year ended 31 December 2010 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.

These model financial statements do not reflect the early adoption of IFRS 9 *Financial Instruments* which is effective for annual periods beginning on or after 1 January 2013 and has not yet been endorsed by the EU.

Amendments to IAS 12

On 20 December 2010, the International Accounting Standards Board (IASB) published *Deferred Tax: Recovery of Underlying Assets – Amendments to IAS 12* ("the amendments"). The amendments provide an exception to the general principle in IAS 12 that the measurement of deferred tax assets and deferred tax liabilities should reflect the tax consequences that would follow from the manner in which the entity expects to recover the carrying amount of an asset.

The Board has provided an exception to this principle when deferred tax assets or deferred tax liabilities arise from investment property measured using the fair value model in IAS 40 and for investment property acquired in a business combination if it is subsequently measured using the fair value model in IAS 40.

The amendments introduce a rebuttable presumption that the carrying amount of the investment property will be recovered entirely through sale.

This presumption is rebutted if the investment property is depreciable and is held within a business model whose objective is to consume substantially all of the economic benefits over time, rather than through sale.

Transition

The amendments to IAS 12 should be applied retrospectively requiring a retrospective restatement of all deferred tax assets or deferred tax liabilities within the scope of the amendment, including those that were initially recognised in a business combination.

The amendments also incorporate the requirements of SIC Interpretation 21 *Income Taxes – Recovery of Revalued Non-Depreciable Assets* (adapted to allow for the introduced rebuttable presumption), ie, deferred tax arising on a non-depreciable asset measured using the revaluation model in IAS 16 should be based on the sale rate. Accordingly, SIC-21 has been withdrawn.

Effective date

The effective date of the amendments is for annual periods beginning on or after 1 January 2012. Earlier application is permitted.

Amendments to IFRS 1 – Removal of Fixed Dates for First-Time Adopters

On 20 December 2010, the International Accounting Standards Board (IASB) published amendments to IFRS 1 *Removal of Fixed Dates for First-Time Adopters*, providing some relief to first-time adopters of IFRSs by:

- Replacing the date of prospective application of the derecognition of financial assets and liabilities of "1 January 2004" with "the date of transition to IFRSs" so that first-time adopters of IFRSs do not have to apply the derecognition requirements in IAS 39 retrospectively from an earlier date; and
- Relieving first-time adopters from recalculating "day 1" gains and losses on transactions occurring before the date of transition to IFRSs.

The amendments are effective for annual periods beginning on or after 1 July 2011. Earlier application is permitted.

Amendments to IFRS 1 – Severe Hyperinflation

On 20 December 2010, the International Accounting Standards Board (IASB) published amendments to IFRS 1 *Severe Hyperinflation*, which provide guidance for entities emerging from severe hyperinflation that are either resuming the presentation of IFRS-compliant financial statements or presenting IFRS-compliant financial statements for the first time.

The amendments are effective for annual periods beginning on or after 1 July 2011. Earlier application is permitted.

Frequent Issues in Determining Income Tax Contingencies

Entities reporting under US GAAP need to fulfil requirements to assess and recognise any uncertain tax positions. The relevant guidance is included in US GAAP codification ASC 740 (formerly in FIN 48).

In the following article, we would like to discuss several situations or transactions which may require recognition of an uncertain tax liability but are often missed in the analysis performed by management of entities.

The first such issue is that management needs to understand what tax position means. For any ***tax position*** taken, the potential uncertain tax benefits need to be analysed (eg it may not be clear whether a certain cost is tax-deductible). The tax position is both a position taken in a previously filed tax return and a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. Taking a certain tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realisability of deferred tax assets.

The term tax position also includes, without limitation:

a. A decision not to file a tax return

b. An allocation or a shift of income or profit between jurisdictions

c. The characterisation of income or a decision to exclude income from a tax return

d. A decision to classify a transaction, entity, or other position in a tax return as tax exempt

For example, an entity does business abroad (eg in Russia) and according to the local laws should register for income tax purposes with Russian authorities (ie, a permanent establishment has originated). However, the entity neither registers nor files a tax return. This is the tax position taken by the entity.

An additional term, which is often discussed when determining uncertain tax positions, is ***"Widely Understood Administrative Practices and Precedents"***. The term is crucial in assessing whether a tax position meets the more-likely-than-not recognition threshold. One can then ask whether a tax position that is technically a violation of effective tax laws can meet the more-likely-than-not recognition threshold taking into account "widely understood administrative practices". The answer to that question would be yes, as ASC 740 states that technical merits of a tax position derive from sources of authorities in the tax law (legislation, legislative intent, regulations, rulings, and case law) and their applicability to the facts and circumstances of the tax position. When the past administrative practices and precedents of the taxation authority in its dealings with the entity or similar entities are widely understood, for example, by preparers, tax practitioners and auditors, those practices and precedents shall be taken into account.

ASC 740 permits consideration of past administrative practices and precedents only when the tax position taken by the entity could technically be a violation of tax law and the tax position is known to be generally accepted by the taxation authority. An example of this concept is the taxation authority's accepting full tax depreciation charges of IT equipment (eg notebooks) that is used for both company and private purposes.

On the other hand, ASC 740 does not provide guidance on when to consider an administrative practice and precedent "widely understood." An entity must consider the specific facts and circumstances of the position and use professional judgment to decide what constitutes "widely understood." An entity that asserts that an administrative practice and precedent is widely understood should document the basis of that assertion including the evidence to support it. Such evidence may include reliable knowledge of the taxation authority's past dealings with the entity on the same tax matter when the facts and circumstances were similar. References to administrative practices and precedents are expected to be infrequent.

The last issue that we would like to highlight in this article is the ***"Balance Sheet Presentation of Uncertain Tax Benefits in Transfer Pricing Arrangements"*** under US GAAP codification ASC 740. Transfer pricing relates to the pricing of intercompany and related-party transactions involving transfers of tangible property, intangible property, services, or financing. These transactions include transfers between domestic or international entities, eg a Czech entity purchases service (running an IT system) from a US entity.

The general transfer pricing principle is that the pricing of a related-party transaction should be consistent with the pricing of similar transactions between independent entities under similar circumstances (ie, an arm's-length transaction). Transfer pricing tax regulations are intended to prevent entities from using intracompany charges to evade taxes by inflating or deflating the profits of a particular unit or units in the same group. Even if a parent corporation or its subsidiaries are in tax jurisdictions with similar tax rates, an entity may have uncertain tax benefits that are subject to the recognition and measurement principles in ASC 740.

An entity's exposure to transfer pricing primarily occurs when the entity includes in its tax return a related-party transaction that was not conducted as though it was at arm's length. An uncertain tax benefit results when one of the related parties reports either lower revenue or higher costs than it should have sustained (depending on the type of transaction). When making a decision whether an entity should recognise a relevant tax benefit in its financial statements (which is usually reflected in the reduction of its tax base) it should consider whether the more-likely-than-not recognition threshold was met. While a benefit is generally more likely than not to result from a certain transaction (eg, some amount of the interest paid, rental from the use of an intangible asset or cost of goods sold can be used as a tax deductible expense), the amount of the benefit is often uncertain because of the subjectivity of valuing the related-party transaction.

An entity must apply ASC 740 to its transfer pricing arrangements. Sometimes an entity with a transfer pricing arrangement may not be able to fully recognise a corresponding tax benefit in its jurisdiction but may recognise a tax benefit in the related party's jurisdiction on the basis of the assertion that the entity will use a special ***"competent authority" procedure*** and will request the procedure be applied if one of the taxation authorities were to propose an adjustment. Under the terms of certain double taxation treaties entered into by different jurisdictions, competent authority is a mutual agreement procedure between countries that is designed to relieve companies of double taxation created by transfer pricing adjustments to previously filed tax returns.

Some entities' managements in this situation assert that if an additional tax were levied in one jurisdiction, an additional tax benefit should be available in the other jurisdiction. Provided there is a double taxation treaty, they believe that the two tax positions would offset each other; hence no uncertain tax benefit needs to be recognised.

However, this presumption might not necessarily work in practice. Typically, double-tax cases are resolved under the principles of the transfer pricing guidelines established by the Organisation for Economic Co-operation and Development ("OECD Guidelines"). To avoid double taxation, one taxation authority makes an adjustment (eg reduces a cost and increases taxable income) that would require a consistent transfer pricing adjustment (eg reducing revenue and decreasing taxable income) in the related party's tax jurisdiction. However, there is no guarantee that an agreement between the jurisdictions will be reached and that double taxation will be avoided.

The answer, in this case, is that an entity should present the liability for uncertain tax benefits and the tax benefit on a gross basis in its balance sheet unless there is a legal right of offset under the double taxation treaty between the two jurisdictions.

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The above-mentioned issues are only a few out of the topics that need to be addressed by the entities' managements when identifying uncertain tax positions and recognising them in their US GAAP financial statements or reporting packages. A sound knowledge of the requirements of the related US GAAP guidance or a consultation with the group tax specialists should help avoid any surprises when the US GAAP accounts are subjected to audit, whether external or internal.

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