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# Accounting news

Czech Accounting, IFRS and US GAAP

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## What is and What is Not the Correction of Prior Period Errors?

In the March issue of Accounting News, we analysed accounting issues of the amendment to Regulation No. 500/2002 Coll., specifically corrections of prior period errors, which took effect on 1 January 2013.

Let us briefly remind new accounting approach for accounting for prior period accounting errors:

- If an error is not material in terms of financial statements, the correction arising from incorrect recognition or non-recognition of expenses and income in prior years is accounted for (the same way as before 1 January 2013) by type using the relevant expense and income accounts, ie through the accounts to which the transaction relates, as was the usual practice to date.
- But if the error is material the correction is made against the equity account ("Other profit or loss of prior years"). In this situation, the correction of errors does not have any effect on the profit or loss for the current reporting period.
- aterial misstatement is an incorrect or omitted disclosure of information that may, individually or cumulatively, impact the decision-making of a sufficiently informed user of the financial statements.
- The company is required to adjust comparative information for the prior reporting period and complete/justify it using notes to the financial statements. The company should also submit an additional tax return and take the adjusted profit or loss into consideration at the General Meeting's decision making in the following period.

In practice, we encounter several different interpretations of the term "prior period error".

The most frequent accounting errors are caused by human error and include:

- an incorrectly-posted document (different amount, incorrect period, incorrectly-selected account – account entries),
- omitted document (non-received invoice) or
- a document that was posted twice.

If the entity identifies such an error, and if the error is material, it will make a correction in the profit or loss of the reporting period or prior period.

Corrections of prior period errors do not have to relate to physical documents that we are missing/that are redundant in the accounting records. These may include accounting entries that are subject to estimates of the company's management, such as reserves or estimated payables/receivables, and that the company will have to settle sometime in the future or that will be settled to the company. And here let us move more into practice.

*In 2012, a company recognised estimated receivables with the anticipation that the supplier will pay CZK 5 million as a bonus for the purchased quantity in the future. In 2013, the company identified that the estimated receivable was overstated and that the payment will not be made. Is this example a correction of a prior period error?*

The answer is both YES and NO: it depends on other circumstances.

The presentation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Management of the Company has made these estimates and assumptions on the basis of all relevant information available to it. Nevertheless, pursuant to the nature of estimates, the actual results and outcomes in the future may differ from these estimates.

If the company recognised estimated payables at the end of the reporting period, however, it deliberately or unintentionally omitted to include all types of costs, or it did not take into consideration all information available before the financial statements date, the difference is the reason for accounting for prior period errors and reporting in the "Other profit or loss of the prior period" line.

A different accounting treatment is taken when the company or its management defends the recognition of estimated receivables as current income resulting from future negotiations with the supplier. A typical example may be the negotiation on the bonus granted for 2012 for the purchased quantity, eg where no contract is concluded or the interpretation of the contract is unclear.


Given the time sequence of individual steps of the granted bonus and the above statement of the company, it is necessary to take into account the substance of the incorrectness of the estimated balances. When recognising estimated receivables, the company had all available and relevant information; however, the result of the negotiation was not in favour of the company. For this reason, it is not a correction of a prior period error; it is rather the impact of the negotiations for 2013. For this reason, the estimated receivables will be released with an impact on the profit or loss of 2013.

### Summary

As every entry in the accounting records requires consideration, it is also necessary to consider the corrections of errors. Corrections of errors may significantly impact the profit or loss of the reporting period if they are not made correctly. The Czech legislation has defined two possible accounting treatments, where the sole perspective is the level of materiality. The reality is not just black and white, it is necessary to analyse and examine the substance of individual transactions.

## Invitation
## Seminar News in Czech Accounting

**Prague, Brno, Ostrava**

As in prior years, we have prepared a popular seminar on the news in Czech accounting, this year providing a summary in accounting legislation and the legal and tax news having an impact on companies' financial statements.

The seminar is predominantly intended for accountants, economists and financial managers preparing or involved in the preparation of financial statements under Czech accounting legislation and the related tax and legal regulations and for all of you who want to learn more about Czech accounting and the latest tax and legal developments.

Seminars will be held in Czech in November and December in Prague, Brno and Ostrava and will be delivered by our professionals.

**Timing**
**Prague:** 12 December 2013
**Ostrava:** 11 December 2013

More information on: www.deloitte.com/cz/events



## IFRS Tips

Today, IFRS Tips cover questions from our clients relating to IAS 16 *Property, Plant and Equipment*.

In June 2012 the *Annual Improvements to IFRSs (2009–2011 Cycle)* were issued which, among others, brought also a minor amendment to paragraph 8 of IAS 16 which deals with the recognition of spare parts and servicing equipment.

**Paragraph IAS 16.8 effective for annual periods beginning prior to 1 January 2013:**
"Spare parts and servicing equipment are usually carried as inventory and recognised in profit or loss as consumed. However, major spare parts and stand-by equipment qualify as property, plant and equipment when an entity expects to use them during more than one period. Similarly, if the spare parts and servicing equipment can be used only in connection with an item of property, plant and equipment, they are accounted for as property, plant and equipment."

**Paragraph IAS 16.8 effective for annual periods beginning on or after 1 January 2013:**
"Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this IFRS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory. "

An entity shall apply this amendment retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

For the sake of completeness, we also include other relating paragraphs of IAS 16.

Definition of property, plant and equipment is stated in **IAS 16.6** – they are tangible items that:

a. are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
b. are expected to be used during more than one period.

Paragraph **IAS 16.7** requires that the cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

a. it is probable that future economic benefits associated with the item will flow to the entity; and
b. the cost of the item can be measured reliably.

We will now demonstrate the application of these requirements on practical examples.

### Example 1 – Stand-by-equipment
**Background**
An entity has installed two turbines. One turbine produces energy for the plant, and the other is used as a backup in case the first turbine fails or is otherwise rendered out of service. The probability that the spare turbine will be used is very low. The spare turbine is necessary, however, to ensure the continuity of the production process if the first turbine fails. The useful life of the stand-by turbine will equal the life of the plant, which is the same as the useful life of the primary turbine.

**Question**
How should this stand-by equipment be accounted for?

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**Answer**
IAS 16.8 states that stand-by equipment qualifies as property, plant and equipment when it meets the definition of property, plant and equipment, i.e. tangible items that

a. are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

b. are expected to be used during more than one period.

Although this definition requires that the entity should expect to use the turbine during more than one period, it does not state that such use should be regular. Therefore, **the spare turbine is classified as property, plant and equipment and should be depreciated from the date it becomes available for use** (i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management).

The useful life of stand-by equipment should be determined by the useful life of the equipment for which it serves as a back-up; in this example, the turbine should be depreciated from the date it is made available for use (i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management) over the shorter of the life of the turbine and the life of the plant of which the turbine is part (assuming the turbine cannot be removed and used in another plant).

Note that, if the residual value of the stand-by turbine is estimated to be significantly higher than the residual value of the primary turbine (because it is expected to be in a better condition at the end of the asset's useful life due to lower usage), this will affect the depreciation charged over that useful life.

The accounting for stand-by equipment is different from the accounting for spare parts which are also considered to be property, plant and equipment but that are 'not available for use'. Refer to example 2 regarding the accounting for spare parts.

### Example 2 - Spare Parts Classified as Property, Plant and Equipment

**Background**
An entity buys five new machines for use in its production facility. Simultaneously, it purchases a spare motor to be used as a replacement if a motor on one of the five machines breaks.

**Question**
Should the spare motor be classified as property, plant and equipment and, if so, when should depreciation commence?

**Answer**
Items such as spare parts, stand-by equipment and servicing equipment should be recognised as property, plant and equipment when they meet the definition of property, plant and equipment. Otherwise, they should be classified as inventories in accordance with IAS 2 *Inventories*. [IAS 16.8]
In the circumstances described, the motor will be used in the production of goods and, once brought into service, will be operated during more than one period. It is therefore classified as property, plant and equipment.

The motor does not qualify as stand-by equipment (see example 1 above) because it will not be ready for use until it is installed. Therefore, the useful life of the motor commences when it is available for use within the machine rather than when it is acquired. It should be depreciated over the period starting when it is brought into service and continuing over the lesser of its useful life and the remaining expected useful life of the asset to which it relates. If the asset to which it relates will be replaced at the end of its useful life and the motor is expected to be used or usable for the replacement asset, a longer depreciation period may be appropriate.

During the period before the motor is available for service, any reduction in value should be reflected as an impairment loss under IAS 36 *Impairment of Assets* at the time impairment is indicated.

## IFRS EU Endorsement Process

On 24 November 2013, the European Union endorsed *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)*. The amendments were published by the IASB in October 2012. They provide an exemption from consolidation of subsidiaries under IFRS 10 *Consolidated Financial Statements* for entities which meet the definition of an 'investment entity', such as certain investment funds. Instead, such entities would measure their investment in particular subsidiaries at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and Measurement*.

You can find more information about amendments to IFRS 10 in our *Accounting news from November 2012*.

Effective date of these amendments in the European Union is the same as the effective date of document issued by the IASB - 1 January 2014 .

The European Financial Reporting Advisory Group (EFRAG) updated its report showing the status of endorsement of each IFRS, including standards, interpretations, and amendments, most recently on 21 November 2013.

As of 24 November 2013, the following IASB pronouncements are awaiting European Commission endorsement for use in the EU:

### Standards

- IFRS 9 *Financial Instruments* (issued in November 2009) and subsequent amendments (amendments to IFRS 9 and IFRS 7 issued in December 2011 and amendment to IFRS 9 *General hedge accounting* issued in November 2013)

### Amendments

- Amendments to IAS 36 *Recoverable Amount Disclosures for Non-Financial Assets* (issued in May 2013)
- Amendments to IAS 39 *Novation of Derivatives and Continuation of Hedge Accounting* (issued in June 2013)

### Interpretation

- IFRIC 21 *Levies* (issued in May 2013)

Click here for the *Endorsement Status Report*

## IASB published amendment to IFRS 9 Financial instruments - General Hedge Accounting

On 19 November 2013 the International Accounting Standards Board (IASB) published an amendment to IFRS 9 *Financial Instruments* incorporating its new general hedge accounting model. This represents a significant milestone as it completes another phase of the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. The new general hedge accounting model provides more opportunities to apply hedge accounting.

We will bring more information about this amendment to IFRS 9 in the next issue of Accounting news.

## I New IFRS Publication by Deloitte

**IFRS Compliance, Presentation and Disclosure Checklist for 2013**

This checklist prepared by Deloitte is developed is to assist the users in determining whether they complied with :

- the recognition, and measurement requirements, and
- presentation and disclosure requirements

set out in the IFRSs in issue as of 30 April 2013.

The items in this questionnaire are referenced to the applicable sections of the IFRSs. The checklist is in Excel, formatted to allow the recording of a review of financial statements, with a place to indicate yes/no/irrelevant for each recognition, measurement, presentation and disclosure item.

You can download *IFRS Compliance, Presentation and Disclosure checklist 2013* for free.



## Accounting for the Franchise Agreement

Franchise has recently become preferred business model and especially in the Central European environment it represents almost ideal approach of the multinational companies to the local markets. Today's article therefore summarizes the key principles of the accounting for the franchise agreement under US GAAP to provide comprehensive understanding of the entire concept.

ASC 952 establishes accounting and reporting standards for franchisors. It addresses franchise fee revenue from individual and area franchise sales and when all material services or conditions relating to the sale have been substantially performed or satisfied by the franchisor. It also establishes accounting standards for continuing franchise fees, continuing product sales, agency sales, repossessed franchises, franchising costs, commingled revenue, and relationships between a franchisor and a franchisee.

Our article however focuses on the most important areas mentioned above:

- Overall principles;
- Franchisors' Deferred Costs;
- Commitments;
- Revenue Recognition; and
- Other Expenses.

### Overall principles

ASC 952 applies to all entities that meet the definition of *franchisor*, that is, the party that grants business rights (*the franchise*) to the party (*the franchisee*) that will operate the franchised business.

As far as the transactions are concerned, it applies to the following ones:

- Franchise fee revenue that is obtained through a franchise agreement;
- Costs associated with franchising activities; and
- Transactions between the franchisor and franchisee.

In order to understand the language used by ASC 952 let us have a look a closer look on the terms.

*Area franchise* stands for an agreement that transfers franchise rights within a geographical area permitting the opening of a number of franchised outlets. Under those circumstances, decisions regarding the number of outlets, their location, and so forth are more likely made unilaterally by the franchisee than in collaboration with the franchisor. A franchisor may sell an area franchise to a franchisee who operates the franchised outlets or the franchisor may sell an area franchise to an intermediary franchisee who then sells individual franchises to other franchisees who operate the outlets.

*Continuing franchise* fees are the considerations for the continuing rights granted by the franchise agreement and for general or specific services during its life.

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*Franchise agreement* then represents written business agreement that meets the principal criteria:

- The relation between the franchisor and franchisee is contractual;
- The continuing relation has as its purpose the distribution of a product or service, or an entire business concept, within a particular market area;
- Both the franchisor and the franchisee contribute resources for establishing and maintaining the franchise;
- The franchise agreement outlines and describes the specific marketing practices to be followed;
- The establishment of the franchised outlet creates a business entity that will, in most cases, require and support the full-time business activity of the franchisee; and
- Both the franchisee and the franchisor have a common public identity.

The payment of an initial franchise fee or a continuing royalty fee is not a necessary criterion for an agreement to be considered a franchise agreement.

*Bargain purchase* is a transaction in which the franchisee is allowed to purchase equipment or supplies for a price that is significantly lower than the fair value of the equipment or supplies.

*Initial franchise fee* stands for a consideration for establishing the franchise relationship and providing some initial services. Occasionally, the fee includes consideration for initially required equipment and inventory, but those items usually are the subject of separate consideration.

*Initial service* represents common provision of a franchise agreement in which the franchisor usually will agree to provide a variety of services and advice to the franchisee, such as assistance in the selection of site, obtaining facilities, advertising, training, bookkeeping, etc.

## Franchisors' Deferred Costs

The deferred costs incurred by franchisors respect the underlying accrual concept of accounting and need to be treated as follows:

- Direct (incremental) costs relating to franchise sales for which revenue has not been recognized shall be deferred until the related revenue is recognized;
- Deferred costs shall not exceed anticipated revenue less estimated additional related costs; and
- Costs yet to be incurred shall be accrued and charged against income no later than the period in which the related revenue is recognized.

## Commitments

Similar to ASC 440 the nature of all significant commitments and obligations resulting from franchise agreements, including a description of the services that the franchisor has agreed to provide for agreements that have not yet been substantially performed, shall be disclosed.

## Revenue Recognition

### Initial franchise fees

Franchise fee revenue from an individual franchise sale shall be recognized, with an appropriate provision for estimated uncollectible amounts, when all material services or conditions relating to the sale have been substantially performed or satisfied by the franchisor.

Substantial performance for the franchisor means that all of the following conditions have been met:

- The franchisor has no remaining obligation or intent—by agreement, trade practice, or law—to refund any cash received or forgive any unpaid notes or receivables;
- substantially all of the initial services of the franchisor required by the franchise agreement have been performed; and
- No other material conditions or obligations related to the determination of substantial performance exist.

If the franchise agreement does not require the franchisor to perform initial services but a practice of voluntarily rendering initial services exists substantial performance shall not be assumed until either the initial services have been substantially performed or reasonable assurance exists that the services will not be performed.

Sometimes, large initial franchise fees are required but continuing franchise fees are small in relation to future services. If it is probable that the continuing fee will not cover the cost of the continuing services to be provided by the franchisor and a reasonable profit on those continuing services, then a portion of the initial franchise fee shall be deferred and amortized over the life of the franchise. The portion deferred shall be an amount sufficient to cover the estimated cost in excess of continuing franchise fees and provide a reasonable profit on the continuing services.

However, at the area franchise sales if the franchisor's substantial obligations depend on the number of individual franchises established within the area, area franchise fees shall be recognized in proportion to the initial mandatory services provided. Revenue that may have to be refunded because future services are not performed shall not be recognized by the franchisor until the franchisee has no right to receive a refund.

The substance of an area franchise agreement shall determine when material services or conditions relating to a sale have been substantially performed or satisfied.

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**Commingled revenue**
The franchise agreement ordinarily establishes a single initial franchise fee as consideration for the franchise rights and the initial services to be performed by the franchisor. Sometimes, however, the fee also may cover tangible property, such as signs, equipment, inventory, and land and building. In those circumstances, the portion of the fee applicable to the tangible assets shall be based on the fair value of the assets and may be recognized before or after recognizing the portion applicable to the initial services.

In case the actual transaction prices are not available for the specific portions, the franchise fees should not be allocated or recognized before all services have been substantially performed.

Although a franchise agreement may specify portions of the total fee that relate to specific services to be provided by the franchisor, the services usually are interrelated to such an extent that the amount applicable to each service cannot be segregated objectively. The fee shall not be allocated among the different services as a means of recognizing any part of the fee for services as revenue before all the services have been substantially performed unless actual transaction prices are available for individual services; for example, through recent sales of the separate specific services.

**Continuing franchise fee**
Continuing franchise fees shall be reported as revenue as the fees are earned and become receivable from the franchisee.

**Continuing product sales**
The franchisee may purchase some or all of the equipment or supplies necessary for its operations from the franchisor. Sometimes, the franchisee is given the right to make bargain purchases of equipment or supplies for a specified period or up to a specified amount, when the initial franchise fee is paid. If the bargain price is lower than the selling price of the same product to other customers or if the price does not provide the franchisor a reasonable profit on the equipment or supply sales, then a portion of the initial franchise fee shall be deferred and accounted for as an adjustment of the selling price when the franchisee purchases the equipment or supplies.

The portion deferred shall be either of the following:

- The difference between the selling price to other customers and the bargain purchase price; or
- An amount sufficient to cover any cost in excess of the bargain purchase price and provide a reasonable profit on the sale, as appropriate.

**Other Expenses**
Costs relating to continuing franchise fees shall be expensed as incurred.

Indirect costs of a regular and recurring nature that are incurred irrespective of the level of sales, such as general, selling, and administrative costs, shall be expensed as incurred.

**Conclusion**
Accounting for franchise operations may vary an agreement to agreement. This article summarizes the basic assumptions and the most common concepts of the franchise accounting. In case you need detail analysis of the franchise related accounting issue do not hesitate to contact Deloitte for further assistance.

If you have any questions regarding any of the articles in this publication, please contact one of the following audit experts:


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