

APPLICABILITY OF IFRS FOR SMES IN THE CZECH REPUBLIC

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crossref <http://dx.doi.org/10.5755/j01.em.17.2.2166>

Abstract

Paper is focused on problems associated with the implementation of IFRS for SMEs in the Czech Republic. There are discussed results of the research done on the base of structural interviews with the representatives of accounting profession (preparer, auditor, user, professional chamber and accounting regulator). Interviewees believe that the major costs of a possible application of the IFRS for SMEs will be additional costs connected to the preparation of second financial statements based on Czech accounting regulation due to the tax purposes. Interviewees are convinced that the major benefit of the adoption of the IFRS for SMEs would be the unification of accounting methods and principles which will lead towards higher comparability of accounting information. Possible application of the IFRS for SMEs might be considered as an opportunity to change the strong linkage of accounting and tax system in the Czech Republic.

Keywords: IFRS, implementation, financial reporting, SMEs, Czech Republic.

JEL Classification: M41.

Introduction

Economists consider that Central and Eastern European (hereafter CEE) countries have pretty well developed market economies, with an institutional environment substantially similar to that of developed Western economies (Rapacki and Prochniak, 2009). This is why these countries are considered good investment opportunities and worthy of conducting researching in. However, the accounting (financial reporting) models in these countries display both similarities with and differences from those in developed economies. Generally, they underwent several reforms, being modelled after one or more models of developed countries, and especially after the European Directives (hereafter ED) and International Accounting Standards/International Financial Reporting Standards (hereafter IAS/IFRS), but their particularities strongly affect the way in which the accounting model is operated.

Small and Medium-sized Enterprises (hereafter SMEs) constitute the most dynamic sector of CEE countries and represent approximately 99% of the business entities in each such country. In the European Union (hereafter EU) these entities have accounting obligations, but recently the EU began focusing on better regulation, modernization and simplification of legislation for them (European Commission, 2008). Consistent with its intent to address the need for international comparability in terms of financial reporting by SMEs, International Accounting Standards Board (hereafter IASB) issued in July 2009 the International Financial Reporting Standard for Small and Medium-sized Entities (hereafter IFRS for SMEs).

The IFRS for SMEs is considered as a response to strong international demand from both developed and emerging economies for a simpler version of IFRSs (Jermakowicz and Epstein, 2010), and the project had the support of the majority of national and regional accounting standard-setters throughout the world (IASB, 2007), including the EU. But EU's position vis-à-vis the IFRS for SMEs is difficult to assess, because different countries and different stakeholders have different positions. The European Commission (hereafter EC) held a consultation in 2010 in order to understand the view of European stakeholders on the IFRS for SMEs, and the European Financial Reporting Advisory Group (hereafter EFRAG) conducted a compatibility analysis.

The remainder of this paper is following: first of all there would be provided some brief literature review on accounting harmonization process and IFRS implementation in Europe. There will be also provided an insight to Czech accounting system. Main objective of this paper is to find out the perception of the representatives of Czech accounting profession about the possible implementation of the IFRS, or IFRS for SMEs respectively as a reporting framework for the Czech companies. The interviews with the representatives of the main actors involved in the accounting process (preparers, auditors, professional bodies, regulators, academics, users) revealed their perception about the characteristics of SMEs and SMEs accounting, the costs and benefits of a possible implementation of the standard and their position vis-à-vis the implementation strategy. The SMEs are not considered as a homogeneous group and while the majority of interviewees agree on the use of quantitative criteria to classify the SMEs, many of them employ other criteria than those officially used. This result might be important in the context in which the regulators might take a decision in relation to the existent criteria.

Literature Review

The process of accounting convergence and the issues related to the implementation of IFRSs worldwide are topics of much interest recently for standard setters, researchers and practitioners. Previous studies on IFRSs application documented an increase in comparability, transparency and quality of financial reporting (Jermakowicz, 2004). Significant impact on the companies' reported equity, increasing volatility of results and a diminishing degree of conservativeness were reported (Jermakowicz, 2004; Jermakowicz & Gornik-Tomaszewski, 2006; Callao *et al.*, 2007). Also, previous studies analyzed the obstacles and difficulties in the application of full IFRSs (Larson & Street, 2004; Jermakowicz & Gornik-Tomaszewski, 2006), and the manner in which these standards are applied in different countries (for example Delvaille *et al.*, 2005).

The national characteristics, i.e. each country's accounting culture and traditions, have developed over (a long) time in close relationship with the political, social and economical environment of each of them, influencing the way in which IFRSs are applied. Factors such as the role of the State, the type of legal system in place, the preferred providers of finance, the relationship between accounting and taxation, the culture, or the role of the accounting profession significantly influence accounting practices (Alexander *et al.*, 2006; Nobes & Parker, 2008). Also, previous research indicated that the lack of political will, rooted in local culture and a strong national outlook prevent a truly harmonized accounting framework (Callao *et al.*, 2007), that a magnitude of differences exists between countries and high costs to eliminate them (Jermakowicz & Gornik-Tomaszewski, 2006); that local traditions exercise a strong influence on the implementation of new concepts, and that tax and legally-based orientation hinder the harmonization process (Larson & Street, 2004; Vellam, 2004).

Insight on Czech Accounting

Until 1918 was Czech lands part of Austrian monarchy and it was applied the Austrian accounting legislation. The requirements on preparation of balance sheet were based on General Austrian Land Code from 1798. General Commercial Code was adopted in 1862 requiring the preparation of balance sheet on yearly basis. It is an interesting fact that this Code was valid even in Czechoslovakia until 1948. In 1964 was adopted new Commercial Code mentioning the requirement that accounting has to follow the long-term state development planning. Seven years later was issued the Act on Unified System of Socioeconomic Information where was mentioned what shall be included within the information system. It was necessary to cover the information from accounting, budgeting, calculation, statistics, and operational evidence (Strouhal *et al.*, 2011).

After the revolution in 1990, Act on Enterprise was adopted requiring from entrepreneurs leading of accounting and providing of information about income, expenditures, accounting profit, assets and liabilities. Entrepreneurs could lead at that time single- or double-entry bookkeeping. The most important day for Czech accounting was 12.12.1991 when Accounting Act (593/1991) with validity from 1992 was adopted. From that time this Act was more than 20x amended (Strouhal *et al.*, 2011). Czech accounting is based on historical costs approach with strong application of prudence principle. To summarize the current stage of accounting legislation, there shall be stated following "open chapters" (Strouhal *et al.*, 2009; Strouhal *et al.*, 2011):

- absolute lack of definition of basic items of financial statements;
- there does not exist any definition of assets, liabilities, equity, expenses or revenues;
- application of "substance-over-form" rule when reporting the financial leases;
- introduction of effective interest rate and amortized costs as a possible measurement base;
- wider spread of fair value approach;
- lack of the liquidity and transparency of markets.

As being a part of European Union all listed companies shall report under IFRS framework since 1st January 2005. Employees of Czech companies which were obliged to shift the reporting paradigms from Czech concept towards IFRS confirmed that this transition was not easy. Except demanding preparation, which includes theoretical preparation, implementation of new accounting rules, adjustment of accounting systems and considering the impact of the new way of reporting for the company, it is necessary to understand the philosophy of the standards and to learn new way of "accounting thinking".

In many EU countries, financial reporting is linked to taxation, which is inconsistent with IASB's philosophy and raises issues for an accurate IFRSs application, and especially that of the IFRS for SMEs. The application of the IFRS for SMEs will imply breaking the traditional bond between the financial statements and the income tax return (Jermakowicz and Epstein, 2010), which makes countries such as France or Germany to oppose to this standard. On the other hand, many emerging markets that became 'new'

EU members have oriented their accounting model towards IFRSs (Sellhorn and Gornik-Tomaszewski, 2006), but they cannot be viewed as a homogeneous block because of their different approaches to accounting reform. Rodrigues and Craig (2007) underlined that these countries should adopt standards which are relevant and useful for them and assess the costs and benefits before making a decision.

The IFRS for SMEs is considered to be “a significant development which may have strong impact on accounting and auditing practice in the future, but the attitude of national regulators and standard-setters is crucial in establishing the limits of this possible impact” (Jermakowicz and Epstein, 2010). EU’s decision is very important, and the EU and/or national jurisdictions will require or allow the IFRS for SMEs or will consider a convergence plan with this standard. Earlier, Sellhorn and Gornik-Tomaszewski (2006) argued that “Due to diversity in size, complexity of operations and ownership structure, it is efficient to allow each firm to assess for itself whether the benefits of IFRS adoption outweigh the costs.”

As already mentioned the accounting legislation in the Czech Republic (with the exception of interpretations) is issued by Ministry of Finance Czech Republic (MF CR). According to the current position of this organ (European Commission, 2010) there could not be expected an obligatory adoption of IFRS for SMEs in the Czech Republic unless required by the European Union. MF CR hopes that IFRS for SMEs will not be widespread due to the differences of local legal frameworks, national economics and the structure of the companies in particular EU countries. For this reason is preferred the revision of current 4th and 7th EU Directive according to current trends and needs.

MF CR also argues that IFRS for SMEs could not bring a higher comparability level as there are not defined any official forms of financial statements and IFRS for SMEs (as well as big IFRSs) just determine what shall be disclosed. Despite of this pessimistic view MF CR believes that IFRS for SMEs might be beneficial just for companies that are subject of consolidation process as it would simplify this process.

Research Methodology

Main objective of this paper is to find out the perception of the representatives of Czech accounting profession about the possible implementation of the IFRS, or IFRS for SMEs respectively as a reporting framework for the Czech companies. For this purpose there have been interviewed the typical representatives of accounting profession, i.e. preparer, auditor of financial statements, user of financial statements, representative of professional chamber and representative of accounting regulator (Ministry of Finance CR). The structured interview consisted of 10 questions about IFRS and IFRS for SMEs implementation. Six questions were common for all interviewees, four questions were based on interviewees profile. The information about interviewees is provided within Table 1:

Table 1. Structure of Interviewees

Interviewee	Acronym	Position, experience	Duration
Preparer	C1	CFO 27 years experience 2 years experience in working with full IFRSs	60 min.
Auditor	C2	local accounting firm – partner + IFRS lecturer 18 years auditing experience 8 years experience in working with full IFRSs	80 min.
User	C3	Bank director of the branch 11 years experience any previous experience in working with full IFRSs	45 min.
Professional chamber	C4	President of Chamber of Certified Accountants CR head of shared-service central of international bank 24 years working experience 17 years experience in working with full IFRSs	90 min.
Accounting regulator	C5	member of National Accounting Board CR university professor, auditor 41 years working experience 8 years experience in working with full IFRSs	65 min.

Interviewees considered Czech Republic as a typical representative of emerging economy from CEE area with the traditional linkage of accounting system to tax system and application of prudence principle in

accounting. Interviewees also points out that the fair value approach could not be widespread in the Czech Republic due to the less efficiency of financial markets.

Results

There could be seen a conflict between official definition of SMEs as provided by the E.U. and the definition mentioned within IFRS for SMEs. Interviewees C1 (preparer) and C3 (user) prefer rather the quantitative definition which is traditional for the continental Europe area, however majority (C2, C4 and C5) prefer the qualitative definition close to IASB definition (see Table 2).

Table 2. Preference of SMEs Definition: Results of Ranking

Definition	C2 (auditor)	C4 (chamber)	C5 (regulator)
D1 – EU definition	4	2	4
D2 – IFAC definition	3	5	3
D3 – IASB definition	2	3	2
D4 – very qualitative definition	5	4	3
D5 – respondent's definition	1	1	1

From the preference of interviewee C4 could be seen the conflict between qualitative and quantitative view. C4 argues: "I guess that the IASB definition best reflects the purpose of SMEs, however in the Czech environment is traditionally preferred quantitative definition. IFAC definition is quantitative, however is based only on fixed assets and the number of employees and the limit of fixed assets is too low."

According to Table 2 respondents prefer their own definition of the SMEs which are following:

- As accounting units under the scope of IFRS for SMEs shall be considered companies which are not part of the group based on public interest, which prepares and reports universal financial statements and they are not micro-entities, i.e. entities with less than 10 employees. (C2 - auditor)
- As accounting units under the scope of IFRS for SMEs shall be considered companies who needn't to have audited financial statements. (C4 – professional chamber)
- As accounting units under the scope of IFRS for SMEs shall be considered companies without audit obligation, however are not microentities and companies with more that limited public responsibility. (C5 – accounting regulator)

The views of interviewees vary when discussing the scope of companies which shall implement IFRS for SMEs. Generally they are for application of this standard by joint-stock companies and limited companies with the special consideration of public interest. Interviewee C3 is aware that IFRS for SMEs could represent an incredible administrative burden for small companies.

Interviewee C2 wonders about the definition of the companies with public interest. "According to this definition (financial sector excluded) there is expected also the number of employees exceeding 4,000. There is a question, whether this definition based on Czech Act on Auditors is not too liberal and why the number of employees is not lower, e.g. 3,000 – in such a case we could have much more companies which have to apply the full set of IFRSs. Of course other companies will apply IFRS for SMEs. There is quite hard to consider as a criterion a turnover – you can reach different turnover as a trader (however it depends on commodities) or as a provider (e.g. services with pretty high value added)."

Application of IFRS for SMEs in the Czech Republic mean a total change of accounting thinking from rule based to principle based. All interviewees believe that the major costs of a possible application of the IFRS for SMEs will be the training expenses and costs with the preparation of second financial statements based on Czech accounting regulation due to the tax purposes (C2, C4, C5). Additional costs shall be also expected with the upgrade of accounting software (C2, C3, C5). Interviewee C1 concludes: "The major costs will be about high quality training and training materials (literature) in Czech language – accounting under IFRSs is not about bookkeeping, which is traditional in our area, but about reporting and presentation. It is not a job for just one person in company, but it will be about collaboration of much more people. This I consider as a problematic, as a lot of managers do not have a good financial background and it is sometimes hard to explain them the accounting issues and effects of their decision on accounting profit. There is also necessary to state that the quality software adapted on the reporting under several reporting frameworks is necessary. In case that there will be any reaction of Czech tax system, it will not bring a simplification of work but it brings just another duty of record keeping from which will be necessary to transform the

accounting profit based on Czech rules. This definitely has to be changed and it will be a crucial element in initial discussion about the possible adoption of this standard in the Czech Republic (and I guess not only here). And I still do hope that it won't be cost over benefit..."

Interviewee C5 also reminds that the introduction of IFRS system (and probably this also might be a case of IFRS for SMEs) to company is made by external accounting experts or auditors what is very expensive.

Interviewees believe that the main benefit of the application of the IFRS for SMEs will be the unification of accounting methods and principles which will lead towards higher comparability of accounting information. Interviewee C1 describes her experiences with "big" IFRS: "I'm experienced just with big IFRSs. I guess that after one has some good knowledge of IFRS, he'll recognize that sometimes it is really upright to report under IFRS rather than under Czech practices. Of course it will have a substantial impact on accounting profit and its distribution, what could be less favourable for shareholders. From this point of view, in case that IFRS for SMEs will be adopted as a legal framework, it has to be really simplified from big IFRSs and all issues have to be explained (what's a problem of current version of IFRS for SMEs as issued by IASB)." Interviewee C3 concludes: "I really hope that the major benefit will be the abolishment of duplicate accounting (accounting for Czech authorities based on Czech accounting x IFRS for parent company)."

Interviewees agree that in case that the IFRS for SMEs is obligatory in whole EU, the benefits will be considerably higher.

Tax authority is considered as a major user of financial statements based on Czech accounting legislation. Interviewees believe that in case that the financial statements will be prepared under IFRS for SMEs framework, the major users will be capital providers (banks, leasing and factoring companies), potential (especially foreign) investors, and owners.

Eventual adoption of the IFRS for SMEs might be considered as an opportunity to change the linkage of accounting and tax system in the Czech Republic. All interviewees hope that in case of IFRS for SMEs adoption there will be made a reasonable change of Income Tax Act. Considering the relation between accounting and taxation as a crucial issue for the eventual adoption of IFRS for SMEs, we are providing the reaction of all interviewees:

- It is necessary to harmonize tax and accounting issues. Calculation of taxes in such case has to be based on IFRS for SMEs. Otherwise it wouldn't make any sense for companies – as the burden will be higher than benefits from this standard. (C1 – preparer)
- In case that the current approach to taxation will be very same, the scissors between accounting and tax point of view will get apart. So it'll be about the reaction of Income Tax Act. (C2 – auditor)
- I can imagine that accounting units prepare their IFRS for SMEs financial statements and for the tax purposes shall be adjusted just some taxable revenues and taxable expenses. (C3 – user)
- I'm pretty aware that the situation will be very same like nowadays – citing the Income Tax Act as a tax base you have to use the profit not based on the IFRS (IFRS for SMEs) influence – i.e. to use the profit based on Czech accounting. Of course there is a question what "profit without IFRS influence" really it is, in case you are posting and reporting under IFRS approach. Therefore majority of companies calculate the differences between IFRS and Czech accounting legislation and these differences have to be a part of the tax profit calculation. From my point of view the best option would be that a taxable profit shall be a profit based on the regulation under which I prepare my financial statements, i.e. in case of IFRS for SMEs, the tax base shall be IFRS for SMEs. (C4 – professional chamber)
- I can imagine that the calculation of tax base could be same like now, i.e. accounting profit shall be adapted for non-tax deductible items. But, to be able to apply this view in practice, it'll be about the adoption of the full IFRS for SMEs or some shorter version as a Czech accounting standards. After that it will be possible to change Income Tax Act and non-deductible costs and expenses will be valid for all companies. (C5 – accounting regulator)

During last 30 years the international accounting faces a shift of reporting paradigms from historical costs towards fair value approach. Within IFRS for SMEs the fair value spread is not such considerable like under "big" IFRS, however it represents an important issue for national accounting legislation in the Czech Republic. All interviewees are aware of a widespread of fair value due to the less liquidity and efficiency of markets in the Czech Republic. It is therefore quite interesting the auditor's view (C2): "I'm for the applying of fair value only in case that there exists for the asset/or liability active market. I'm for the elimination of

the qualified estimation – in such a case there shall be rather preferred historical cost.” Interviewee C5 agree and follow up: “Fair value accounting has a general problem in case, that the fair value is not objectively measured. Fair value shall be used “prudently” in SMEs books and this value has to be really reliable and objective. From this point of view I rather prefer historical costs accounting with impairment tests.”

Within this research has been also discussed whether IFRS for SMEs could be required or permitted for individual and consolidated financial statements. Interviewees prefer to require IFRS for SMEs for consolidated financial statements instead of current “group manuals”. From comparability point of view interviewees believe that it could be vital to at least permit IFRS for SMEs for individual financial statements for the comparability purposes. Interviewee C2 admits: “I’m not for the applying of big IFRS for consolidated accounts in case that the consolidating group will be based on let say 6-7 rather small companies.”

Summarizing the results of the interviews there shall be highlighted following issues:

- professional accountants hope that the major benefit of the IFRS for SMEs adoption will be elimination of duplicate accounting, unification of the accounting system within international groups and the higher comparability of accounting data,
- elimination of the linkage of national accounting system to tax system or preparation of such improvements of tax legislation that will make IFRS for SMEs capable to apply as a reporting framework,
- professional accountants and regulator are aware of the higher initial costs linked to shift of reporting frameworks,
- professional accountants and regulator are for sensitive use of fair value approach,
- professional accountants and regulator believe that the major users of financial statements based on IFRS for SMEs will be capital providers and potential investors.

Conclusions

SMEs play an important role in the global economy and their accounting issues are recently under debate, especially after the issuance of the IFRS for SMEs by the IASB in 2009. This paper exemplifies the case of emerging economies and their stakeholders’ positions vis-à-vis this standard. It is already known that these countries are more oriented towards international standards for legitimating purposes, but they have an underdeveloped accounting profession.

The comparative analysis between the national regulations and the IFRS for SMEs provided evidence that there are differences between the accounting systems and that the magnitude of the differences between the national regulations and the IFRS for SMEs would influence the cost of a possible adoption of the standard. This analysis revealed that accounting regulations (and practices) is not fully harmonized, that there are conceptual problems in the current regulations and that these regulations are influenced by taxation and is of a rule-oriented approach.

The interviews with the representatives of the main actors involved in the accounting process (preparers, auditors, professional bodies, regulators, academics, users) revealed their perception about the characteristics of SMEs and SMEs accounting, the costs and benefits of a possible implementation of the standard and their position vis-à-vis the implementation strategy. The SMEs are not considered as a homogeneous group and while the majority of interviewees agree on the use of quantitative criteria to classify the SMEs, many of them employ other criteria than those officially used. This result might be important in the context in which the regulators might take a decision in relation to the existent criteria.

Besides the strong links to taxation, the interviews revealed that accounting profession and accounting is underdeveloped and users do not trust in reported information and they do not use the information produced by accounting in a high extent. Also, the users do not make high pressures to obtain more high quality accounting information. Under these circumstances, the change in the accounting system (i.e., the possible adoption of the IFRS for SMEs) is considered as a means of education and changing the accounting profession and the business environment.

Future research is needed in order to further investigate the role of institutional characteristics of our country, and to identify the most appropriate convergence mechanisms. Also, empirical research might provide an evidence about the costs/benefits and effects of the changes in the accounting regulations. The political issues, such as the position of the national regulators, the relationship with taxation, the lobbying issues, the strategies of professional bodies, might also deserve proper academic attention.

Acknowledgment

This paper is one of the research outputs of the project P403/11/0002 registered at Czech Science Foundation (GA ČR).

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