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Regulation of the Accounting in the Czech Republic

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This paper deals with the evolution of the regulation of accounting in the Czech Republic. The Accounting Act was adopted in 1993 and till 2007 was fourteen-times amended (the Income Taxes Act was even amended more than seventy-times till 2007). Text deals with the changes of the measurement basis in Czech accounting moving from the historical value concept to fair value concept. Paper also compares the requirements on financial statements using CAS (Czech Accounting Standards) with IFRS. The major problems detected are reporting for leases and facultative cash-flow statement. Currently under Czech accounting legislation the major terms are not defined (e.g. assets, liabilities, equity, expenses, and revenues).

Field of Research: Accounting, Reporting, Developing Countries

1. Introduction

In the year 2002 the Council issued Regulation 1606/2002 whereby it stipulated certain duties on the part of companies listed on European stock exchanges to compile their consolidated accounting statements in accordance with International Financial Reporting Standards (IFRS/IAS), effective as of 2005 at the latest. Although IFRSs are not deemed an equal alternative to Czech laws regulating the compilation of financial reports, Act 563/1991 Sb., on accounting, nevertheless stipulated that selected accounting entities are obliged to proceed in accordance with IRFSs to compile their financial statement. This exception applies to consolidated accounting entities which have issued securities listed on the official stock exchange market in EU member states. Other accounting entities may choose whether to compile their financial statement in accordance with Czech statutory regulations or in accordance with IFRSs.

Unlike international standards, Czech accounting regulations lack a glossary of definitions for basic elements of financial statements, which is why we shall use the definitions applied in IFRS/IAS standards, namely in the Framework.

2. Literature Review and Methodology

Czech Accounting Act was adopted in 1992. From this year until nowadays there were made several important changes, but unfortunately it should be stated that there are still significant differences between Czech accounting principles and International Financial Reporting Standards. The most significant problem of financial statements and items shown is the complete inconsistency of measurement bases and the application of the historic (acquisition) cost, fair value and the present value (Buus, Strouhal, Brabenec, 2007, p. 36).

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Jindrichovska & McLeay (2005) also states that "the Czech market is similar to more developed markets, at least in one respect: There is statistically significant evidence of different market effects of profits and losses, in that profits are more persistent than losses. However, contrary to the findings in more developed markets, there is no statistically significant evidence of earnings conservatism in the Czech market" (p. 635). These results are most probably due to the continuing influence of restrictive tax regulations that mitigate any tendency towards conservatism, as well as the transitional nature of the economy. In conclusion, if changes in market prices signal good news and bad news about future risky outcomes, there is no evidence of asymmetry in the Czech market in accounting for such risks.

3. Period 1993 – 2001

Legislation effective during the years under review:

Year	**Accounting**	**Taxes**
1993	Accounting Act • 563/1991 Measures of MF CR • V/20 100/1992 • V/2-30 864/1992 • V/1-31 388/1992 • 281/23 655/1993 • 281/50 550/1993	Income Taxes Act • 586/1992, 35/1993, 96/1993, 157/1993, 196/1993 VAT Act • 588/1992, 196/1993
1994	Accounting Act • 563/1991 • 117/1994 Measures of MF CR • 281/69 810/1993 • 281/13 510/1994 • 281/23 655/1993 • 281/73 574/1993 • 281/64 287/1994 • 281/50 550/1993	Income Taxes Act • 323/1993, 42/1994, 85/1994, 114/1994 VAT Act • 321/1993, 42/1994, 136/1994
1995	Accounting Act • 117/1994 Measures of MF CR • 281/73 250/1994 • 281/43 180/1995 • 281/64 287/1994 • 281/65 550/1994 • 281/65 549/1994	Income Taxes Act • 259/1994, 32/1995, 149/1995, 118/1995 VAT Act • 258/1994
1996	Accounting Act • 117/1994 Measures of MF CR • 281/71 699/1995 • 281/71 701/1995 • 281/80 380/1996	Income Taxes Act • 87/1995, 248/1995 VAT Act • 133/1995
1997	Accounting Act • 117/1994 Measures of MF CR • 281/66 191/1996 • 281/80 380/1996	Income Taxes Act • 316/1996, 18/1997 VAT Act • 133/1995
1998	Accounting Act • 227/1997	Income Taxes Act • 151/1997, 209/1997, 210/1997,

	Measures of MF CR • 281/89 070/1997 • 281/53 678/1998 • 281/80 380/1996 • 281/24 015/1998	227/1997, 168/1998, 149/1998, 333/1998 VAT Act • 151/1997, 208/1997
1999	Accounting Act • 227/1997 Measures of MF CR • 281/53 678/1998 • 281/93 488/1998 • 281/24 015/1998	Income Taxes Act • 111/1998, 144/1999, 170/1999, 225/1999 VAT Act • 208/1997, 129/1999
2000	Accounting Act • 227/1997 Measures of MF CR • 281/78 180/1999 • 281/24 015/1998	Income Taxes Act • 63/1999, 129/1999, 3/2000, 17/2000, 27/2000, 72/2000, 100/2000, 103/2000, 121/2000 VAT Act • 129/1999, 17/2000, 22/2000, 100/2000, 256/2000
2001	Accounting Act • 492/2000 Measures of MF CR • 281/84 064/2000 • 281/19 863/2001 • 281/24 015/1998 • 281/119 365/2000	Income Taxes Act • 132/2000, 241/2000, 340/2000, 492/2000, 120/2001, 117/2001, 239/2001 VAT Act • 241/2000, 141/2001, 262/2001

In the period under review, the Accounting Act governing the keeping of both double-entry and single-entry accounting. In 1993 - 2001 the only admissible accounting period was the calendar year, while the financial year was not allowed as a permissible alternative.

The law defined the following mandatory parts of the Financial Statements: Balance Sheet, Profit and Loss Statement and the Annex. The Annex contained information about valuation, depreciation and book-keeping methods and procedures applied during the accounting period and, last but not least, information necessary for the due assessment of the status of assets and liabilities, financial standing and profit/loss of the accounting entity. Mandatory audit was required for businesses that generated a net turnover exceeding CZK 40,000,000 (≈ USD 1,500,000) and whose net assets exceeded CZK 20,000,000 (≈ USD 750,000).

Valuation

In the period under review, the Accounting Act defined the following valuation bases:

- Purchase cost, i.e. the purchase price of the asset plus costs connected with its acquisition,
- Current replacement cost, i.e. the cost at which the asset could be acquired in the current period,
- Purchase price, i.e. the price at which the asset was purchased, excluding any costs connected with its acquisition, and
- Production costs, i.e. direct costs of production and a portion of indirect production-related costs.

The *purchase cost* concept was used to value:

- Purchased intangible assets,

- Purchased tangible assets (if the accounting entity obtained them by means of donation, then the current replacement cost had to be applied), and
- Purchased inventories.

The *production costs* were used to value:

- Tangible assets produced,
- Inventories produced,
- Intangible assets produced, and
- Livestock increase.

The *purchase price* was used to value securities and equity interests.
The *nominal value* was used to value:

- Cash and valuables, and
- Receivables and payables.

If assets or liabilities were acquired in a foreign currency, then the following exchange rates were used to translate the asset value to Czech crowns:

- Foreign exchange - buy for receivables,
- Foreign exchange - sell for payables and purchased securities and tangible assets,
- Foreign exchange - middle - for current account transactions, and
- Foreign currency - middle for cash transactions and the purchase or usage of valuables.

For purposes of valuing a decrease in inventories and securities, it was possible to use the weighted arithmetical average value and the FIFO method.
If it was determined during a stock-taking procedure that the selling price of stock reduced by costs of sale was lower than the cost stated in the books, then companies created an adjustment. However, liabilities could also be revalued upward if the value of liabilities was higher than the value stated in the books.
Adjustments were also applied to all kinds of asset value decrease.

4. Period 2002 – 2003

Legislation effective during the years under review:

Year	Accounting	Taxes
2002	Accounting Act • 353/2001 • 575/2002 Measures of MF CR • 281/89 759/2001 • 281/97 417/2001	Income Taxes Act • 483/2001, 453/2001, 50/2002, 145/2002, 128/2002, 210/2002, 308/2002, 260/2002, 575/2002 VAT Act • 477/2001, 276/2002, 575/2002
2003	Accounting Act • 575/2002 Decree No. 500 • 500/2002 Measures of MF CR • 281/89 759/2001 • 281/97 417/2001	Income Taxes Act • 198/2002, 162/2003 VAT Act • 320/2002, 322/2003

In the period under review, the Accounting Act governing the keeping of both double-entry and single-entry accounting. In 2002, the option of having the financial year as the accounting period was introduced as an alternative to the calendar year. The Accounting Act defined the financial year as an accounting period that may begin on the first day of a month other than January. If an accounting entity intends to use the

financial year instead of the calendar year, it must file a relevant application with the tax authority competent according to the registered office of the accounting entity.
In 2002, for the first time ever in the Czech legislation governing accounting, a definition appeared of the true and fair view of the object of accounting and the company's financial standing. A view is considered true if the content of items in the Financial Statements corresponds to the actual status, which must be captured in accordance with the accounting methods, which the company has to apply pursuant to the Accounting Act. The view is then considered fair if the accounting methods used were applied in a manner ensuring a fair view.
In 2002 - 2003 the following documents were considered as accounting books:

- *Journal(s)*, in which accounting entries are ordered in terms of time and companies use them to demonstrate the booking of all accounting transactions in the given accounting period,
- *General Ledger*, where the entries are structured by substance,
- *Analytical account books*, which specify the General Ledger entries in greater detail, and
- *Off-Balance-Sheet account books* (until 2002 accounting entities in the Czech Republic did not have to keep any off-balance-sheet records at all).

Since 2002, in accordance with the Accounting Act the Financial Statements include the Balance Sheet, Profit and Loss Statement and the Annex, which explains and supplements information stated in the principal statements. The Annex may furthermore include a Cash Flow Overview and a Report on Equity Changes. However, it is true that, in practice, the companies that have to be audited compile these statements according to the auditor's requirements.
Since January 1, 2002, the following companies have to have their Financial Statements reviewed by an auditor:

- Joint-stock companies, and
- Other businesses if, as of the Balance Sheet date of the accounting period, for which the Financial Statements are audited, and for the immediately preceding accounting period, they exceeded or reached at least two of the following three criteria:
    1. Total Assets exceeding CZK 40,000,000 (≈ USD 1,600,000),
    2. Net Turnover exceeding CZK 80,000,000 (≈ USD 3,200,000), and
    3. Average adjusted headcount over 50.

Valuation

In 2002 some changes were introduced with respect to the valuation bases. The Czech legislation abandoned the option of valuing assets using the purchase price, and the term "nominal value" was replaced with the term "explicit value", although the two terms have a completely identical meaning. The Czech accounting legislation newly adopted the concept of fair value.
The *fair value* is to be understood as follows:

- Market value or
- A value determined by a qualified appraiser or expert if the market value is not available (unfortunately, this is a very frequent case in the Czech Republic).

If the costs of determining the fair value are too high, however, accounting entities may state the assets and liabilities at their originally recorded values.

The Accounting Act defines the market value as a value announced at a domestic or foreign exchange or other public market. If the assets are listed at a domestic stock exchange, then the market value is to be understood as the closing price published by the stock exchange on the business day as of which the valuation is done. However, if the assets are not listed at a domestic stock exchange but are listed at foreign stock exchanges, the market value is then to be understood as the highest of the closing prices that was achieved on approved markets of foreign stock exchanges on the business day as of which the valuation is done. If the said markets are closed on the valuation date, the market value is to be determined using the price published on the last business day preceding the given valuation date.

The *purchase cost* concept is used to value:

- Purchased intangible assets,
- Purchased tangible assets (if the accounting entity obtained them by means of donation, then the current replacement cost has to be applied),
- Purchased inventories,
- Ownership interests,
- Securities,
- Derivatives, and
- Purchased debt.

The *production costs* are used to value:

- Tangible assets produced,
- Inventories produced,
- Intangible assets produced, and
- Livestock increase.

The *nominal value* is used to value:

- Cash and valuables, and
- Receivables and payables.

If assets or liabilities were acquired in a foreign currency, then their value needs to be translated to Czech crowns using the effective exchange rate of the central bank, i.e. Czech National Bank. Exchange differences arising during the accounting period are stated in aggregate profit/loss terms; however, exchange differences arising from the revaluation of receivables and payables as of the Balance Sheet date are stated in the Balance Sheet. Moreover, in the case of exchange losses a provision for exchange losses needs to be created. Nonetheless, the practice is such that since January 1, 2003 all exchange differences, including those established as of the Balance Sheet date, are always stated in aggregate profit/loss terms.

The following categories of assets and liabilities need to be revalued to their *fair value* as of the Balance Sheet date:

- Derivatives,
- Securities (excluding securities held to maturity, securities representing ownership interests with significant or controlling influence, and the company's own securities held), and
- Portions of assets and liabilities secured with derivatives.

For purposes of valuing a decrease in inventories and securities, it was possible to use the weighted arithmetical average value and the FIFO method.

If it was determined during a stock-taking procedure that the selling price of stock reduced by costs of sale was lower than the cost stated in the books, then companies created an adjustment. However, liabilities could also be revalued upward if the value of liabilities was higher than the value stated in the books. Adjustments were also applied to all kinds of asset value decrease.

5. Period 2004 – 2006

Legislation effective during the years under review:

Year	Accounting	Taxes
2004	Accounting Act • 437/2003 • 257/2004 Decree No. 500 • 472/2003 CAS	Income Taxes Act • 438/2003, 49/2004, 19/2004, 47/2004, 257/2004, 280/2004, 359/2004, 360/2004, 436/2004, 628/2004, 676/2004 VAT Act • 354/2003, 437/2003, 438/2003, 102/2004, 235/2004
2005	Accounting Act • 669/2004 • 495/2005 Decree No. 500 • 472/2003 • 397/2005 CAS	Income Taxes Act • 562/2004, 669/2004, 217/2005, 342/2005, 357/2005 VAT Act • 635/2004, 669/2004, 124/2005, 215/2005, 217/2005, 377/2005, 441/2005
2006	Accounting Act • 179/2005 • 57/2006 • 81/2006 • 230/2006 Decree No. 500 • 397/2005 CAS	Income Taxes Act • 362/2003, 179/2005 VAT Act • 545/2005, 109/2006, 230/2006, 319/2006

In the period under review, the Accounting Act only governed the keeping of double-entry accounting. According to the Act, accounting entities are to be understood as follows:

- Legal entities with their registered office in the Czech Republic,
- Foreign persons if they do business or carry out any other activity in the Czech Republic,
- Organization units of the government,
- Individuals who are as entrepreneurs entered in the Commercial Register,
- Other individuals acting as entrepreneurs if their turnover, as defined by the VAT Act, exceeded CZK 15,000,000 (≈ USD 600,000) in the previous calendar year,
- Other individuals who keep accounting based on their free will, and
- Other individuals who are entrepreneurs and members of an association without legal subjectivity, provided that at least one of the association members is an accounting entity.

Following the accession of the Czech Republic to the European Union on May 1, 2004, firms that are corporations and that have issued securities in a regulated market of a Member State of the European Union have to compile their Financial Statements according to the IFRS/IAS standards. However, these firms face a major disadvantage in the fact that, for taxation purposes, they must determine their profit/loss according to the Accounting Act. If there are differences in booking specific transactions according to the IFRS/IAS and according to the Czech legislation, the firms must ensure that during a potential tax inspection they can document and demonstrate the differences arising from different methods used to book and state their profit/loss according to the IFRS/IAS and the profit/loss before tax, and the accounting unit has to:

- Add to the accounting vouchers relevant numbers of the accounts to which the accounting transaction was credited or debited without any IFRS/IAS effect (if the amount is also different, then the amount needs to be stated as well),
- Make other entries on facts that are subject to accounting in a manner consistent with the accounting methods and entries in the General Ledger and in the Analytical Account Book, in a structure defined by the Czech accounting laws and regulations, and
- Prepare an overview corresponding to the Profit and Loss Statement, which the Czech accounting legislation requires from an accounting entity that compiles its Financial Statements according to the Czech laws and regulations.

In the period under review, certain changes were introduced with respect to the auditing of the Financial Statements. Joint-stock companies are subject to mandatory audit if they meet at least one of the three criteria (as described in the section pertaining to 2002 – 2003). And the real “highlight” is an absolutely irrational and dangerous paragraph stipulating that accounting entities do not have to have their Financial Statements audited if they are compiled during a bankruptcy proceeding, and this applies to 3 years starting on the first day after the bankruptcy was initiated. Since the tunneling of firms (or financial fraud) is fairly popular in the Czech Republic, most experts have not yet been able to grasp the purpose of this provision.

Valuation

There have not been any major changes concerning valuation in the period under review. An additional obligation was introduced, namely to revalue, as of the Balance Sheet date, receivables to fair value, which the accounting entity acquired and determined for trading, and also obligations to return securities, which the accounting entity alienated and did not re-acquire until the valuation date.
Exchange differences are only stated in aggregate profit/loss terms. The Accounting Act also introduced a definition of the fixed exchange rate, which is to be understood as an exchange rate set in a company’s internal rule based on a foreign exchange market rate published by the central bank, which the accounting unit uses for a pre-defined period of time. However, as of the Balance Sheet date the accounting entity must revalue all its assets and liabilities using the current exchange rate set by the central bank with no exceptions whatsoever.

6. Summary

It is clear from the above description of the development over the past fifteen years that there are still major differences between accounting concepts applied in the

Czech Republic and those established in the IFRS/IAS standards. The most critical issues and differences can be summarized as follows:

- An absolute lack of definitions of core elements of the Financial Statements (assets, liabilities, equity, expenses, revenues);
- It is impossible to value some items using their present value (for long-term receivables and liabilities);
- It is impossible to use the fair value concept (except for realizable securities, securities held for trading and derivatives); therefore, assets cannot be revalued to a higher value;
- The issue of stating objects of financial lease (in the Czech accounting environment, the principle does not apply of substance prevailing over form; therefore, the object of lease is stated in the Balance Sheet of the lessor, i.e. the lease firm, not in the Balance Sheet of the lessee - the lessee only enters the asset in its off-Balance-Sheet records and cannot even depreciate it),
- There is a lack of requirements for public disclosure in comparison with the IFRS/IAS standards.

Since the IASB new standard is to be promulgated this year, governing the financial reporting of small businesses and medium-size enterprises, we can ask the question to which extent this standard will be reflected in amendments to the Czech accounting legislation. The expert public hopes for significant changes; nonetheless, the determining factor will be the standpoint of the Ministry of Finance.

References

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Accounting Act No. 563/1991

Decree No. 500/2002, which implements certain provisions of Act No. 563/1991, on Accounting, as amended, for accounting entities that are entrepreneurs keeping double-entry accounting

Measure of the Ministry of Finance CR Ref. No. V/20 100/1992, that defines the chart of accounts and accounting procedures for entrepreneurs

Measure of the Ministry of Finance CR Ref. No. V/1-31 388/1992, that defines the structure of items in the Balance Sheet and in the Profit and Loss Statement, and their material definitions for entrepreneurs

Measure of the Ministry of Finance CR Ref. No. 281/50 550/1993, that defines the content of the Annex to the Financial Statements for entrepreneurs

Measure of the Ministry of Finance CR Ref. No. 281/71 701/1995, that defines the content of the Financial Statements for entrepreneurs

Czech Accounting Standards for accounting entities that keep accounting pursuant to Decree No. 500/2002.

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Value Added Tax Act No. 588/1992

Value Added Tax Act No. 235/2004