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COMPARISON OF THE REQUIREMENTS FOR REPORTING OF LISTED AND NON-LISTED COMPANIES: SOME ISSUES FROM THE CZECH REPUBLIC

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Abstract

The globalization and the expansion of markets, as well as the general progress in the technologies available have brought new problems to the compilation of financial reports and to the ascertainment of trading income of supranational corporations and groups in accordance with statutory regulations of countries involved. From the year 2005 should public listed companies in the Czech Republic report under IFRS framework, while the non-listed companies still report under Czech accounting principles. This duality may lead to discrepancies with respect to the identification of free cash flow, which is considered the basic information required for the income-based business valuation. The subsequent text therefore deals with the basic difference in the identification and valuation of assets and liabilities in listed companies (which report under IFRS) and nonlisted companies (which report under Czech regulations).

Key words: financial reporting, IFRS, Czech Republic
JEL classification: M41, G30

1. Introduction

Without common accounting standards, there could be 27 different national methods of accounting, in addition to the use of IFRS and of US GAAP which is permitted by some EU countries [Whittington, 2005, 129]. Brown and Tarca [2005, 201] warn that "the future of the IASB is tied to the successful introduction of IFRS in Europe". The EU motivates the regulation by referring to the enhanced international comparability and transparency of financial statements and improved access to the international capital markets resulting from IFRS usage [Cuijpers and Buijink, 2005, 519].

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 con-

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solidated accounting statements in accordance with IFRS. Therefore beginning in 2005, a large number of listed enterprises, exhibiting significant heterogeneity in size, capital structure, ownership structure and accounting sophistication, started to apply international standards for the first time. The demand for detailed application guidance will increase substantially, as will the demand for uniform financial reporting enforcement throughout the European Union. Schipper [2005, 122] states "if the IASB declines to provide detailed implementation guidance for IFRS, I predict that preparers and auditors will turn elsewhere, perhaps to US GAAP or perhaps to jurisdiction-specific European GAAP, for that guidance".

In addition to the use of IFRS by listed companies, many countries adopt international standards for unlisted companies or model their domestic standards on international standards. The Australian government has decided to adopt international standards for the statutory accounts of all domestic companies from 2005, and New Zealand has indicated the year 2007. A recent survey by Deloitte and Touche [2003] suggests that more than 90 countries will either require or permit IFRS for listed companies by 2005. This provides an interesting example for those who argue that accounting standards should be left to competition in the marketplace [e.g. Watts and Zimmerman, 1986].

The requirements for group listed enterprises to prepare IFRS reports from 2005 is established in most transitional economies, but it is still unclear to what extent other enterprises will prepare IFRS financial statements. Concerns about the lack of suitably trained accountants and auditors and the lack of efficient markets to ensure reliable fair values for the IFRS financial statements, have already been expressed [Eccher and Healy, 2000; Sucher and Alexander, 2002]. This may cast doubt on whether the financial statements issued under IFRS will be reliable. Indications are that in most of the transitional economies of Eastern and Central Europe, other non-listed enterprises will not have to prepare financial statements according to IFRS [Sucher et al., 2005, 574].

Although IFRS are not deemed an equal alternative to Czech laws regulating the compilation of financial reports, Act 563/1991, on accounting, nevertheless stipulated that selected accounting entities are obliged to proceed in accordance with IFRS 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 IFRS.

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 standards, namely in the Framework. Concerning the initial recognition under Czech laws, the Accounting Act (Section 24) identifies the following valuation alternatives: historical costs, replacement costs, production costs and nominal values. As of the date of balance, the accounting entities are obliged to record their assets and liabilities as follows:

Entry	**Upon acquisition**	**As of the date of balance**
Intangible fixed assets	historical costs/ replacement costs/ production costs	net book value or the lower of the following (net book value vs. market price)
Depreciated tangible fixed assets	historical costs / replacement costs/ production costs	net book value or the lower of the following (net book value vs. market price)
Non-depreciated tangible fixed assets	historical costs / replacement costs/	or the lower of the following (historical costs /replacement costs/ production

	production costs	costs vs. market price)
Shares and ownership interests – controlling influence	historical costs	equivalent valuation
Shares and ownership interests – substantial influence	historical costs	equivalent valuation
Realizable securities (long-term)	historical costs	fair value
Inventory purchased	historical costs / replacement costs	or the lower of the following (historical costs /replacement costs vs. market price)
Own products in inventory	production costs	
Receivables	nominal value/ historical costs	or the lower of the following (nominal value/ historical costs vs. market price), or fair value (derivative contracts or receivables hedged by derivatives)
Cash	nominal value	
Short-term securities	historical costs	fair value
Payables	nominal value	as entered in the inventory

Source: our analysis; Accounting Act 563/1991

In the Czech Republic, values are usually measured through historical prices, while donated or gratuitously procured assets are measured by reproduction price which is the approximate equivalent of the reproduction cost as defined by IFRS. Under certain circumstances, also the realizable value and the fair value also may be used as the measurement bases for financial accounting. At the same time, Czech regulations strictly ignore measurement methods based on present value [Strouhal and Židlická, 2008, 46].

2. Financial Statements in the Czech Republic

Financial statements in the Czech Republic (for companies reporting under national regulation) comprise: balance sheet, profit and loss statement, and notes. Financial statements may also include a cash-flow statement and the statement of changes in equity, i.e., they are facultative under Czech Accounting Act (§18), not even for the accounting entities which are liable to statutory audit [Strouhal, 2006, CD].

Balance Sheet (see Appendix 1)

Unlike Czech regulations, international standards do not define accruals and deferrals as separate accounting entries, but rather integrate them among receivables (deferred revenues) and liabilities (accrued expenses). At the same time, the Czech regulations do not require the separate reporting of discontinued operations, while IFRS stipulate that discontinued operations be disclosed and presented separately in accordance with IFRS 5.

Profit and Loss Statement (see Appendices 2 and 3)

Pursuant to the Fourth Directive of the E.U., accounting entities should compile the profit and loss statement vertically, allowing for the presentation of expenses either according to their nature or function. However, if the profit and loss statement is arranged with respect as to the function of entries involved, accounting entity must also include a schedule disclosing the operating costs classified with respect to their nature.

There exist two basic differences between the profit and loss statement compiled in accordance with Czech rules and in compliance with IFRS: IFRSs have revoked the obligation to report extraordinary expenses and extraordinary revenues; Czech regulations have included the entries re-allocation of expenses to inventory and fixed assets and change in inventory of finished goods and work in progress among the revenue entries. However, since IFRS do not recognize the above entries as revenues, they have been included among adjustments to operating expenses.

Disclosure

Firms with international stock exchange listings face additional capital market pressures [Meek et al, 1995] and stock exchange requirements [Cooke, 1992] that may lead them to increase their level of disclosure. Investors demand information about the domestic operating environment and domestic accounting regulations of foreign listed firms [Nobes and Parker, 2002]. Many stock exchanges around the world allow foreign registrants to prepare their financial statements according to IFRS or US GAAP. Prior studies show that the level of disclosure [Cooke, 1992; Meek et al., 1995] and the probability of using non-local GAAP [El-Gazzar et al., 1999; Murphy, 1999; Ashbaugh, 2001; Dumontier and Raffournier, 1998; Leuz and Verrecchia, 2000; Leuz, 2003] are positively associated with the number of foreign stock exchange listings of a firm. The impact on financial reporting of cultural differences has been well documented [Nobes and Parker, 2002, 18-19; Radebaugh and Gray, 2002, 42-48]. There may be more disclosure by UK or US companies that have a culture of disclosure of information than by companies that have not traditionally aimed to produce especially transparent financial statements (e.g. companies from transitional economies such as Czech Republic).

3. Czech Standards versus IFRS

Intangible fixed assets

Intangible fixed assets are intangible assets which the accounting entity intends to keep for more than one accounting period (the Income Tax Act also specifies that the input price of intangible fixed assets must exceed the sum of CZK 60 000). The value of intangible fixed assets is measured by historical cost (acquisition price) for assets purchased, by production costs for internally generated assets and by replacement price for assets obtained gratuitously. Intangible fixed assets are subject to amortization; the amortization period is stipulated by the Income Tax Act. The intangible fixed assets must be accounted for in compliance with the prudence principle as of the balance day, meaning that the accounting entity should disclose either the net book value of the intangible fixed assets, or the lower present market price.

Under IFRS, intangible assets may be measured by two basic models over the period of possession: historical costs model and the revaluation model. If the accounting entity applies the historical costs model, the assets shall be subject to continual amortization and their value shall be decreased and disclosed in compliance with IAS 36. If the accounting entity uses the revaluation model, the asset shall be regularly revaluated to its fair value and consequently depreciated. If the asset value is impaired, the accounting entity must proceed in compliance with ISA 36. The revaluation to fair value which is higher than the original value shall be accounted for under the revaluation fund and recognized in equity, while the impairment loss should be recognized in profit or loss. Unlike under the Czech regulations,

the incorporate expenses as well as research and development should be accounted for under expenses. Under certain circumstances, R&D may also be capitalized in the balance sheet. Goodwill pursuant to IFRS 3 should be disclosed only in the event that the goodwill was generated by acquisition. Advance payments may be offset against debts from the same title.

Tangible fixed assets

Tangible fixed assets include tangible assets which the accounting entity intends to keep for more than one accounting period (the Income Tax Act also specifies that the input price of the tangible fixed assets must exceed CZK 40 000). The value of the tangible fixed assets is measured by historical costs (acquisition price) for assets purchased, by production costs for processed production and by replacement price for assets obtained gratuitously. Tangible fixed assets are subject to depreciation, the accounting books should show the so-called book depreciation. The tangible fixed assets must be accounted for in compliance with the prudence principle as of the balance day, meaning that the accounting entity should disclose either the net book value or the lower present market price of the tangible fixed assets concerned.

Under IFRS, tangible assets may be measured by two basic models in the course of possession: historical costs model and the revaluation model. If the accounting entity applies the historical costs model, the assets shall be subject to continual amortization and their value shall be a be decreased and disclosed in compliance with IAS. If the accounting entity uses the revaluation model, the asset shall be regularly revaluated to its fair value. If the asset value is impaired, the accounting entity must proceed in compliance with IAS 36.The revaluation to fair value which is higher than the original value shall be accounted for under the revaluation fund and recognized in equity, while the impairment loss should be recognized in profit or loss.

The rules pertaining to finance leases under IFRS are completely different from Czech regulations. While in the Czech Republic, the subject of finance lease is accounted for by the lessor in his balance sheet (usually a leasing firm) and the lessor also writes it off, and the lessee is only entitled to include lease instalments among his expenses and must disclose the asset under off-balance sheet records, IAS 17 applies the rule substance over form.

Inventories

Inventories count among current assets. Usually we distinguish between inventory purchased and processed production. At the time of acquisition, the value of inventories is measured by the historical costs (acquisition price - for purchased inventories), replacement price (for inventories obtained gratuitously) and production costs (for processed production). For the measurement of the value of inventory decrement, the same cost formula should be used for all inventories with similar characteristics as to their nature and use to the enterprise. For groups of inventories that have different characteristics, different cost formulas may be justified, including FIFO, weighted average cost formula, fixed inventory price with independent disclose of variations or the actual acquisition price.

Accounting entities are entitled to choose from the continual inventory system (method A) and periodic inventory system (method B) for inventory records. In the continual inventory system, accounting entities record inventories via account groups Materials, Processed Production and Goods and allocate inventory decrement to costs or to income adjustments. In the periodic inventory system accounting entities record the purchased inventories in the relevant costs accounts and during the accounting period do not even use balance-sheet en-

tries such as Inventory of Materials and Consumables or Inventory purchased for resale - In storage. Instead, as of the balance day, the accounting entity transfers the initial status of the balance-sheet entries into costs and based on the stock-taking results transfers from the costs the final status of purchased inventories into the balance sheet. Inventories must be accounted for in compliance with the prudence principle as of the balance day, meaning that the accounting entity must record the inventories with their book value or with their lower present market value.

The following differences between Czech regulation and IFRS shall be stated. It is necessary to bear in mind that processed production in the accounts change in inventory and re-allocation of expenses to inventory and fixed assets do not comply with the definition of revenues, which is why they are recorded as adjustments to operating expenses. At the same time, IAS 2 stipulates much stricter terms with respect to the measurement of processed production, particularly in the following areas:

- separation of fixed production overhead and variable overhead; only that part of the fixed production overheads which is based on the normal capacity of production facilities may be allocated to the costs of conversion,
- prohibition of re-allocation of expenses not expended productively (such as scrap and waste),
- permission to allocate administration overheads only provided that the accounting entity demonstrates incontestable relation between the expended administration overhead and inventory procurement.

Receivables, payables and credits

The short-term and long-term receivables constitute a part of current assets, while short-term and long-term are included among liabilities. Both receivables and payables should be measured by their nominal value, unless obtained in exchange for consideration, in which case they should be measured by their acquisition price. Accounting entities must convert receivables and payables in foreign currencies as of the moment of their measurement in Czech crowns in accordance with the current exchange rate of the Czech National Bank or a fixed exchange rate. As of the balance date, the accounting entities must also convert the sum of pending receivables and payables to Czech crowns in accordance with the current exchange rate of the Czech National Bank. Foreign currency exchange losses and gains should be recognized in the income statement.

The deferred tax assets and liabilities arise from the differences between the accounting and taxation concept of selected accounting entries. The accounting for the deferred taxes is based on the assumption that the accounting entity will apply the deferred tax in a later period than the due tax. The recognition and the accounting for the deferred tax is mandatory for entities which form the consolidation units (i.e. enterprises within a group) and the accounting entities which are obliged to compile the final accounts in their full extent. Other accounting entities may account for the deferred tax at their own discretion. The accounting for the deferred tax does not affect the tax liability. At the same time, it affects the sum of disposable profit, i.e. profit intended for allocation. The calculation of the deferred tax should be based on the balance-sheet approach. Deferred tax should be recognized for all temporary differences arising from the different accounting and tax view of entries included among assets and liabilities. It is also necessary to account for differences between the tax and tax residual price of the deductible tangible and intangible fixed assets as well as for another differences such as the reserves created beyond the scope of statutory duty, rec-

ognition of adjustments to inventories or receivables etc. Credits and financial assistance should be measured at their nominal value.

According to IFRS, receivables and liabilities are generally perceived as financial assets or financial liabilities to be recognized in accordance with standards applicable to financial instruments. Long-term receivables and payables should be recognized under IFRS in their present value; the settlement of the difference between the present and nominal value is performed by means of an effective interest rate. Due to their time character, short-time receivables and payables are normally recognized at their nominal value and the discounting to their present value is not required.

Provisions

The Accounting Act stipulates that the only genuine profits should be accounted for in the balance sheet and that the accounting entity should take into consideration all predictable risks and possible losses affecting its assets and liabilities and known to the accounting entity at the time of balance sheet compilation, as well as should include all devaluations regardless of the fact whether the accounting entity showed profit or loss in the accounting period. The accounting entity is entitled to use provisions, adjustment entries and write-offs for that purpose. Provisions are aimed to cover future expenses or liabilities, whose purpose is known and which are expected to occur, but whose timing or amount is uncertain. However, provisions may not be used adjust the value of assets.

Provisions may be used only for the purpose for which they have been originally recognized. Logically, provision may only be used to the maximum amount in which it was created; and provision may not have a credit balance. The balance of reserves at the end of the accounting period should be transferred to the subsequent period. Accounting entities are obliged review provisions entered in the books at the end of the accounting period, and assess their tenability and amount. If it is discovered that the reason for which the provision has been created has lapsed, the provision should be dissolved in its full extent. If it is discovered that the provision is for a different sum than it is due, it should be adjusted. In the balance sheet provisions should be accounted for under liabilities.

The Accounting Act defines 5 types of provisions – provisions for risks and losses, provisions for income tax, provisions for pensions and similar obligations, provision for restructuring, technical provisions or other provisions pursuant to special legal regulations (statutory provisions). The Provision Act stipulates three types of provisions for enterprises: ***provision for repairs of tangible assets***, provision for cultivation of crops, other provisions (for the removal of mud from a pond, for the redevelopment of plots affected by mining, for the settlement of mine damage or provisions stipulated by special laws as costs required to achieve, ensure or maintain revenues).

IAS 37 does not allow the recognition of a provision for the repair of tangible assets. Since in accordance with IAS 16, assets with different useful life are depreciated separately, and expenditures for asset maintenance or replacement are activated subsequently.

4. Conclusion

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 and Brabenec, 2007, 36]. At present, the principle of measurement based on the historical cost fades out as it is being gradually re-

placed by the IFRS trend of reporting fair values, which are, however, difficult to measure in less transparent markets. At the same time, the reporting based on fair value is includes a hidden danger of future volatility of such values and the consequent impact of the changes on financial statements.

Jindřichovská & McLeay [2005, 36] 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". 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.

Czech approach to financial accounting and reporting can be summarized as follows:

Hierarchy of Czech GAAP	The main regulation is the Act on Accounting, with respect to which the Ministry of Finance issues implementing decrees. Accounting procedures are described in more detail in the Czech accounting standards for entrepreneurs issued by the Ministry of Finance. Other important sources of law are the Income tax Act, the Act on Securities, the Commercial Code and the judgments of the Supreme Court. Interpretations of accounting problems are issued by the National Accounting Board. However, they are not legally binding.
Objectives of Financial Statements	Financial statements should provide information on the financial standing of the entity. Furthermore, they are used as the basis for distribution of profits and for tax purposes.
Formal Regulations and Audit Obligation	Financial statements must be issued in the Czech language and set out in Czech currency (CZK). Entities that exceed particular size criteria in two successive financial years are subject to audit. Companies that are subject to audit are obliged to prepare their financial statements within six months after the balance sheet date, other companies within three months after the balance sheet date.
Components of Financial Statements	Financial statements comprise: a balance sheet, an income statements and explanatory notes. Financial statements can also contain: a statement of changes in equity and a cash-flow statement (which are facultative). Comparative information has to be disclosed in respect of the previous period.
Format of Financial Statements	***Balance sheet:*** Czech GAAP set out a mandatory order and structure of items. Only a more detailed structure or merging of pines is permitted in certain cases. ***Income statement:*** Czech GAAP prescribe a standard format, costs must be presented in one of the formats (function or nature). The same adjustment as in the case of the balance sheet is permitted. The explanatory notes must at least contain information required by the implementing decree.
Users of Financial Statements	Tax authorities, market regulators and other institutions, creditors, investors and management are the crucial target audience of financial statements. The primary focus is placed on compliance with statutory reporting duties with respect to the state.
Measurement	Except for specific components of assets (derivatives and certain securi-

	ties) that are measured at fair value, measurement at historical cost is required. Fair value measurement is also performed in the case of some business transformations or in-kind contributions to registered capital with respect to the contribution recipient.

Source: our analysis

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Appendix 1 – Balance Sheet (under Czech Accounting Standards)

TOTAL ASSETS	**TOTAL EQUITY AND LIABILITIES**
A. Receivables from subscriptions	***A. Equity***
B. Fixed assets	*A.I. Registered capital*
B.I. Intangible fixed assets	*A.II. Capital funds*
B.II. Tangible fixed assets	*A.III. Reserve funds, statutory and other funds*
B.III. Long-term financial assets	*A.IV. Profit/loss of previous years*
C. Current assets	*A.V. Profit/loss of current period (+/-)*
C.I. Inventory	***B. Liabilities***
C.II. Long-term receivables	*B.I. Provisions*
C.III. Short-term receivables	*B.II. Long-term liabilities*
C.IV. Short-term financial assets	*B.III. Short-term liabilities*
D.I. Accruals	*B.IV. Bank loans*
	C.I. Accruals

Appendix 2 – Income Statement by Nature (under Czech Accounting Standards)

+	Revenues from merchandise
-	Costs of goods sold
=	***Sales margin***
+	Production
-	Production consumption
=	***Value added***
-	Personnel expenses
-	Taxes and fees
-	Depreciation of tangibles and intangibles
+	Revenues from disposals of fixed assets and materials
-	Net book value of fixed assets and materials
-	Change in operating provisions and adjustments
+	Other operating revenues
-	Other operating expenses
+	Transfer of operating revenues
-	Transfer of operating expenses

=	***Operating profit/loss***
+	Revenues from sales of securities and ownership interests
-	Securities and ownership interests sold
+	Revenues from long-term financial assets
+	Revenues from short-term financial assets
-	Expenses associated with financial investments
+	Revenues from revaluation of securities and derivatives
-	Cost of revaluation of securities and derivatives
-	Change in financial provisions and adjustments
+	Interest revenues
-	Interest expenses
+	Other financial revenues
-	Other financial expenses
+	Transfer of financial revenues
-	Transfer of financial expenses
=	***Profit/loss from financial operations***
-	Income tax on ordinary income (due, deferred)
+	**Ordinary income**
+	Extraordinary revenues
-	Extraordinary expenses
-	Income tax on extraordinary income (due, deferred)
=	**Extraordinary income**
-	Transfer of ratio in profit/loss to partners
=	**Profit/loss of current accounting period**

Appendix 3– Income Statement by Function (under Czech Accounting Standards)

+	Sales of products, goods and services
-	Costs of sales
=	***Gross profit/loss***
-	Selling expenses
-	Administrative overheads
+	Other operating revenues
-	Other operating expenses
=	***Operating profit/loss***
	Financial operations and Extraordinary items – see P/L statement by nature