

Audit Specifics for SME Businesses in Czech Republic

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Abstract—Small and Medium Sized Enterprises represent the most important group within national economies. Paper deals with the auditing issues in this companies from the Czech Republic firstly introducing the accounting and auditing legislature in the country. The crucial part of this paper is focused on the inaccuracies found during the auditing process in these companies.

Keywords—Auditing, SMEs, Czech Republic, financial statements, harmonization.

I. INTRODUCTION

BUSINESS environment is relatively stabilized after 20 years of market economy in the Czech Republic and legislation governing it as well. But in Czech legislative rules are small and medium-sized business not limited, but they can be divided into groups, depending:

- if they are an independent accounting subject
- is so, what is the concept of their financial statement
- if their duty is to perform an audit

In the following paper we will discuss businesses registered in Czech Republic even that the same, sometimes slightly different rules are applied for foreign subjects with their activities in Czech Republic.

When a business becomes accounting entity, it is its duty to perform double-entry accounting. Accounting entity is business if:

- it is a corporate entity, that means a corporation according to Civil Code, regardless of legal form. Civil Code is specifying rules for capital investment (joint stock company, limited liability company) and for personal investment (public company, limited partnership company.) Such businesses are registered in a Business Registry.
- it is a personal entity, registered in Business Registry. Such a registration is mandatory and guided by a Civil Code if during two consecutive accounting

periods business turnover is bigger than 120 mil.CZK (about 480 000 EUR) Such business can be registered voluntarily, but there is no advantage doing so, contrary, it is forcing business in such case to publish accounting results for example and other duties. During 90's, at the beginning of market economy there was an obligation to register if such a business performed foreign trade, this was later canceled.

- if it is a personal entity with turnover during very last accounting period bigger than 25 mil.CZK (about 1 mil. EUR)
- if it is a personal entity deciding freely to register, regardless on turnover
- if it is a personal entity and shall became a member of association without legal entity but even just one member of such association is an accounting entity

Personal entities not belonging to either of above groups are keeping just tax files, showing their base for tax purposes. This is guided by income tax law.

Accounting law is specifying two types of accounting entities.

- Accounting entities with accounting and final statement using international accounting standards (IFRS) obligatory. This is valid for businesses emitting shares registered on regulated stock exchange in EU member states. To determine a tax base no such statement can be used but it has to be transformed according to the Czech accounting rules and that can be used for tax base specification.
- Accounting entities compulsory using Czech accounting rules. It is valid for all others accounting entities as well. Economical results coming from accounting statements are used as a base for taxation and transformed according to tax laws.

Looser rules are used for consolidated accounting statements where the first group mentioned must complete them using IFRS system, others can choose if they use international accounting standards or Czech rules.

Audit is obligatory in the Czech Republic for all companies exceeding the following limits: (i) assets (gross) higher than 40 million CZK (about 1.6 mil. EUR); (ii) net turnover higher than 80 mil. CZK (about 3.2 mil EUR); and (iii) more than 50 employees during the period (in average).

For joint-stock businesses there is audit required in case of reaching or surpassing one of the limits specified above, for others two of the above limits. There is no limit if business is performing audit voluntarily.

Manuscript received August 27, 2010. This paper is one of the research outputs of the project GA402/09/0225 registered at Czech Science Foundation (GA ČR).

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II. AUDITING PROFESSION IN THE CZECH REPUBLIC

Auditors are relatively young profession in Czech Republic. Even that during planed economy period existed some form of closing accounts auditing (accounting revision), they were without central rules and more of formal than content-oriented inspection. Real auditor profession was born in 90's and first mentioned were auditors by Czech legislature in law about businesses with foreign assets participation in 1989. Accounting statements than were for the first time audited by two independent auditors-experts, appointed by Ministry of Finance after their examination. This Ministry issued in the same year Bill of Auditors, where this profession was for the first time officially recognized. Professional organization-Auditors Union was established as well, transformed in 1992 into Chambers of Auditors according to the auditing law, passed the same year. From then to 2009 such law was many times updated according to the auditors' needs and EU harmonization processes.

In relation with Directive 2006/43/EC of the European Parliament dd. May 17th, 2006 about obligatory audit yearly and consolidated closing accounts new law was passed in Czech Republic (No.93/2009 Sb.) where this Directive is implemented. Audit is therefore respected as an activity in public interest and as such a subject of strict regulation. In Czech Republic as a first step in such regulation is professional self-regulation by Chamber of Auditors of Czech Republic and its bodies. Second step is a control by an independent organization-Counsel for public supervision of audit, based on the same law. Counsel duty is to increase credibility of auditors' profession and accounting subjects audited, toward foreign and/or domestic investors, broad public and State institutions. Operation body is 5 members presidium, selected and nominated by Minister of Finance in cooperation with the central Czech National Bank. Presidium is helped by other committees and they are:

- committee for system quality observance and disciplinary measures
- committee for educational coordination and profession exams
- committee for audits cooperation and coordination
- supervisory committee

In country there is (as of Dec. 31, 2009) 350 audit firms and 1325 auditors (out of which 754 are audit firms employees.) 571 are private auditors.

Small and medium-sized audit firms and individual auditors serving small and medium-sized businesses depend on each other. Small business where audit is necessary by law shall choose small audit firm or individual auditor unless, according to his foreign owner requirement is the same auditor selected as of parent business is using. Deciding factor is many times the price paid for audit, smaller by small audit firms than by large ones.

Basic question for audit-regulating bodies on domestic and international level is how different can be an audit for small of big businesses. The answer is always the same, audit is an

audit and the rules shall be the same for everyone, data users shall, from closing accounts, be assured about their integrity. Deciding factor therefore is audit quality according to the international auditing standard ISQC1-Auditing firms Quality management, Historical financial information verification, other verification contracts and related services. It is obvious that one of the factors influencing this standard application is the accounting entity size, client and audit firm as well. Standard is thus not observing some procedures irrelevant for individual auditors without employees for example, but audit services quality cannot be influenced than.

Czech audit law is stating that auditor must (during his work) use according to the international audit standards issued by IFAC, International Federation of Auditors, its Czech version issued by Czech Chamber of Auditors. But even IFAC as an international audit standards issuer is conscious of limits by small audit firms or individual auditors serving small and medium-sized businesses, influenced by their administrative load and their application is many times formal. Use of some standards not for such auditors relevant and in a final part it is adding to the cost of audit. Committee for small and medium-size accounting and auditing profession issued guide for their quality management where instructions are included how to perform their services. Guide is destined for small audit firms with few employees and individual auditors without them.

Big audit firms, especially those on the Net are using their own quality control guidance, formulated by inner or corporate regulations. Specifics are used mostly by small firms and individual auditors.

Following issues can be observed from this point of views:

- issue of observing ethic code imposed on auditor
- issue of observing quality requirements on audit performed

Chamber of Auditors is supplying any auditor with Czech version o IFAC Ethic Codex and they are committed to follow it. Basic ethical principles included in this IFAC codex are:

- integrity and objectivity, professional performance, this has to be guaranteed by auditor
 - trustworthiness, his fidelity and honesty and conduct. Auditor can find themselves find in situation where they are under constrain, influencing their objectivity. Forms of such a constrain can be different, such as presents from clients, excessive hospitality etc. Those are a situation to avoid expert competence is necessary condition for quality of audit services. Entering this field, auditors are examined by Chamber of Auditors, verifying their professional quality. They are required to participate on 60 hours minimum of continuous professional education, supervised by Chamber.

Chamber of Auditors is screening:

- confidential information preserving, and secrecy, this is given by law. Secrecy exempt can be given by audited business itself or by Chamber. Law is

- specifying what is not a secrecy.
- All those requirements are relevant to a ethical demand of auditor independence. It can be endangered by many means, especially by those situations:
 - material interest, when a great financial gain is possible from services performed for client, It can be a investment participation on client business or distinctive size of fee paid for audit services. Or it can be a loan from a client and/or accepted guarantee, all this being a threat to objectivity
 - Self-auditing of own case is often endangering auditor independence with small and medium-size businesses. If the client accountant, completing the accounting statement is not qualified enough to arrange its parts, he might ask auditor for help, for example cash flow statement or supplement. There are cases of accounting statement being prepared by accountant. He is than auditing his own work.
 - Cases of protectionism are if auditor shall became a broker for client stock or directly selling them. It is impossible as well if an auditor and simultaneously a layer is representing client in legal cause or litigating in dispute with third party.
 - Kinship is the another situation, where the client and auditor are relatives. It can be relation among owners or members of management which can influence audit outcome.
 - Blackmail from client side is a danger if client is threaten by using another auditor services if the audit results are negative. Accepting presents and excessive hospitality are committing auditor to influence audit size and results.

Second field emphasized recently in connection with Directive 2006/43/EC is audits quality control. System of quality control is governed by Chamber of Auditors, using its own body, Supervisory Committee, as required by law. This Committee is closely cooperating with Counsel for public supervision of audit. In case of shortcomings in auditors service the case is presented to the Disciplinary Committee, issuing disciplinary measures according to the case importance (warning, fine or temporary/final suspension. Most often cases seen on such supervisory inspections are not keeping audit standards especially:

- working without or using just formal audit plan and not-following strategy according to ISA 300 in regards to the planning of the performed procedures and evidence

- Insufficient evidence of auditor services, from auditor files is cannot be seen which procedures auditor did performed
- Insufficient assessment of contract risks, it is not clear which risk factors were judged and if at all (ISQC1)
- Lack of importance level assessment and uncertainty how to work with this level during testing and sample selection (ISA 320.)
- Insufficient review of accounting subject information system which shall care about information quality and complexity (ISA 500 and 530.)
- Risk of fraud is not assessed or lack of (or bypassing) of internal business control mechanism.
- Insufficient or missing evidence of closing accounts in relation to the accounting balance and/or evidence in closing accounts supplement and annual balance sheet (ISA 500)

III. MOST FREQUENT INACCURACIES DURING AUDITING OF SMES

Without common accounting standards, there could be 27 different national methods of accounting in addition to the use of IFRS and US GAAP, which are permitted by some EU countries [3]. [1] warn that “the future of the IASB is tied to the successful introduction of IFRS in Europe”.

In the year 2002, the European Parliament and the Council of the European Union 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 IFRS. Therefore, beginning from 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.

The requirements for group listed enterprises to prepare IFRS reports from 2005 were 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 [2]. 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.

One of the major problems of Czech accounting is its close relation to the income tax. Since the financial statements are used as a basic indication for income tax base, many

businesses tend to minimize this result and thus income tax base. Rarely there is the opposite situation-to maximize the tax base, this is the case when on business economical results are directly tied to the management bonuses. This is but the trend within large corporations, small and medium-sized businesses with one or few owners are finding the ways how to extract profit by other means, mostly by using tax-deductible expenses. There are many other possibilities, some of them breaching the tax law, businesses are hoping that accounting inspection will not find them. Let's see some of them:

Long-term assets

To classify an asset as long-term business is not respecting the assets life-time but tax limits according to the Czech income tax law being 40 000 CZK (or 1 600 EUR) for tangibles and 60 000 CZK (2 400 EUR) for intangibles. Assets up to those limits, even if its lifespan is longer than one year is accounted for as a direct cost. Invoiced it is often by more than one invoice so it seems as more different items.

Inventories

Inventories evidence is many times formal, annual stock-taking is omitted and inventories discrepancies not curbed. Inventories are filed into accounting system even if they do not exist or are of no use, without appraising their real value and correcting entry. (It has no tax efficiency) Large deficiency there exist within unfinished production, not entered into accounting mainly in services sector. Another inadequacy is not to include secondary cost into inventories, which were not utilized.

Accounts payable

Accounts payable are not collected on time, nor the correcting entry used or just partially if its influence tax base. Confirming letters are not sent to request the confirmation of active debts. Accounting is many times using out-of date debts or debts by businesses in dissolution or already dissolved.

Travel expenses

This sector is one of the most used to draw untaxed cash from business, especially there, where the owner is an employee as well. As travel expenses are paid non-existent trips or fake ones, persons are this way financing by business money their vacation or holidays. Business reports are not required and use of cash is inconclusively documented.

Other private expenses entering business accounting

Partners in small businesses are many times using business money as their own, not drawing the line between their and business cash. As expenses are often entered small items or equipment serving personal needs instead.

Fictional accrued tax formation

Most misused reserve, lowering the tax base is a provision for long-term assets repair. Such a reserve is part of expenses

influencing taxation and business is forming it without really thinking about repair works. In future it has to dissolve this reserve and increase tax base, but this delays the tax payment.

Reducing sales record

Selling for cash is an occasion to reduce sales record and thus income level. Reason is again an effort to lower tax base. This can be done for purpose by business owners or by employees, thus making money out of business inventories, keeping cash for themselves.

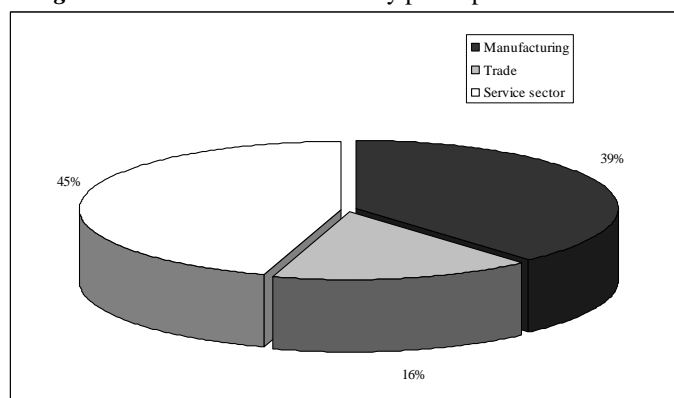
Fictional Invoices

Issuing the invoice for services never performed has double effect. Invoice is entered into receivables file and thus is lowering the tax base and more, accounting entity can claim VAT tax return. This way of avoiding taxation is but on verge of being illegal.

IV. RESEARCH FOCUSED ON SMEs' AUDITING

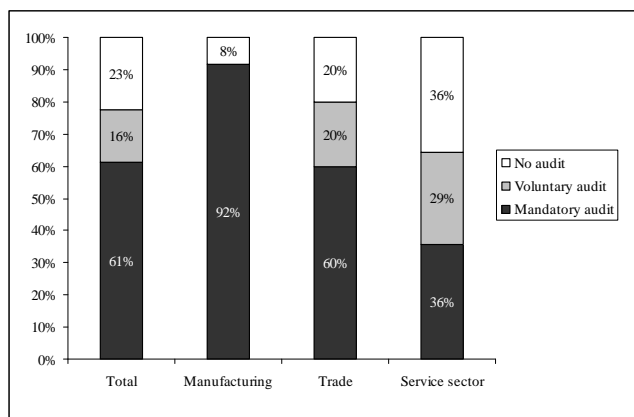
Research is summarizing the answers from 31 companies with less than 250 employees. Out of those, 12 companies are manufacturing, 5 are trading businesses and 14 businesses are in service sector. Figure 1 is explaining this structure.

Fig 1– Business structure of survey participants



Questions used in research survey were oriented on audit in small and medium-sized businesses Main findings was their stance toward audit and their experience with it. Results are shown on Fig.2

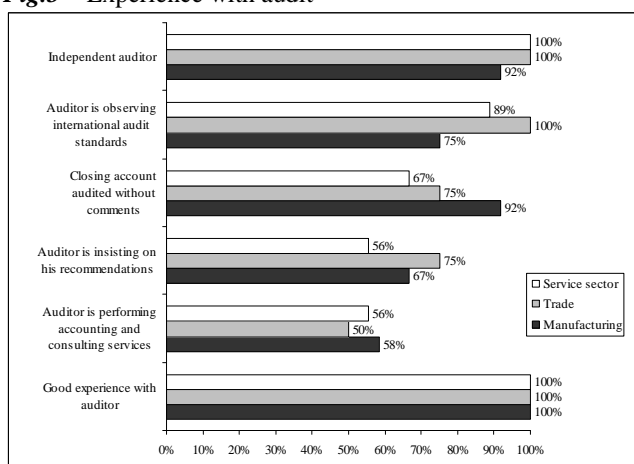
Fig.2 – Business participation on audits



From this survey it can be seen that more than for 90% of manufacturing businesses is audit obligatory. Share of trading businesses is around 60% and service sector share is smallest with 36%. It is interesting to note that all businesses were participating on mandatory audit, for just one of the manufacturing businesses was audit not mandatory, it did not participated.

Businesses with audit experience, 25 of them, did answered 6 questions regarding their experience with audit and its style and satisfaction with it. Results are presented on Figure 3.

Fig.3 – Experience with audit



As it emerges from results there are not significant differences among different business sectors. It can be stated that:

- majority of auditors is working independently, that means they are not relatives and do not verify their own works.
- Auditors are observing during their services international audit standards, since it is required by audit law (it is a question if audited businesses can judge this)
- most of the statements issued is without comments, that means that closing accounts are true and authentic and are showing a real economy situation.
- Not always auditor insists on its recommendations but if it shall influence his statement, he insist on them,

since it could not issue a statement without reservation.

- Auditors can perform accounting and consulting services but not to the point where they later could verify their own work, auditor can advise during the accounting period and he can recommend for example accounting entry change but he cannot participate on closing account.
- All participating businesses were satisfied with auditors work.

V. CONCLUSION

Accounting audit in small and medium-sized businesses by small audit firms and individual auditors has its specifics; it is recognized by international and domestic audit regulators. On one side there is an effort to minimize administrative load, on the other side there is an effort to maximize audit quality. Quality control is possible only by proper documentation, records on performed work. Of a great help there is a variety of software for auditors, keeping those records in good shape and quality. This is of concern of the Committee for small and medium-size audit firms by IFAC. One of its projects is free software for auditors-members of IFAC. Regular member of this organization is Czech Chamber of Auditors.

Updating Audit law valid since 2009 quality level requirement was increased. Demands on auditors working on closing account SME are bigger. Quality of their services and international standards observance is supervised by Chamber of Auditors. This is the reason for which our research of quality of SME auditors' performance shall continue from our side.

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