Impact of International Accounting Harmonization on National Legislature (Czech Level)

JIŘÍ STROUHAL
University of Economics Prague
W. Churchill Square 4, 130 67 Prague 3
CZECH REPUBLIC
strohal@vse.cz

Abstract: - Use of harmonized accounting standards may reduce investor’s uncertainty and can thus reduce the cost of capital. It can significantly improve the communication between business users and all their statements. Due to the globalization of business and international harmonization of financial reporting Czech Republic experiences a shift in paradigms from historical costs accounting towards fair value measurement. Paper provides an analysis between national accounting legislature and international referential. There is also provided how the ability to measure accounting harmonization can be helpful from the perspective of a globalized world. A comparative analysis between Czech accounting regulation and IFRS or IFRS for SMEs show the level of compatibility between these three sets of accounting regulation.

Key-Words: - International harmonization, globalization, IFRS, econometric tools, Czech Republic

1 Introduction and Literature Review

SMEs sector forms as much as 99 % of business entities around the world. They have fewer resources to use on influencing financial standards and the system is arguably less responsive to their needs. The tightening of professional accounting standards and the proliferation of extensive and complex accounting pronouncements governing financial reporting have added complexities to the preparation of financial statements and have further exacerbated their financial reporting problem. The need to establish appropriate accounting standards for SMEs is one which invariably draws common agreement but generally, there is no consensus achieved on the recommended solutions. The biggest obstacle is existence of 27 different systems of accounting within the European Union, which have to be harmonized. The question about whether or not accounting standards should apply equally to large and small companies has been the subject of much debate and concern by accountancy bodies in many countries [16] and has become known as the “Big GAAP/Little GAAP” debate [8].

Size is an important determinant for accounting differentiation. The empirical research studies leaving still a considerable gap of ignorance about the influence of an entity’s size on the attitudes of its representative and its stakeholders with regard to financial reporting. Some studies have concentrated on the particularities of SMEs with regard to the objectives, purposes and users of financial statements of SMEs. Those are, e.g. [1, 3, 6, 9, 19, 22]. Other studies focused on the attitudes and behavior of SMEs with regard to financial statements’ publication and audit [10].

However, the arguments for differential reporting seem to be stronger the important argument now appears to be, not whether this is an appropriate approach but rather how accounting standards for large entities and SMEs should differ [11, 17]. It must be decided what criteria will be used for distinguishing different classes of reporting entities and these should reflect cost/benefit considerations [11].

Specific accounting standards created for a category of enterprises that is so difficult and subjective to define and identify might be ineffective, difficult to interpret and also, difficult to regulate and to maintain [12].

One the main arguments for extending IFRS implementation to SMEs’ accounts is that global financial reporting standard (if applied consistently) will enhance international comparability and understandability [18], as well as, the transparency and accountability of SMEs accounting reports [12]. Greater information relevance, which is also beneficial for management and market efficiency are other suggested benefits for SMEs by the extension of IFRS [12].

There is some evidence that suggests the difficulties or the failure of the adoption process: the lack of political will, rooted in local culture and a
strong national outlook prevented a truly harmonized framework, a magnitude of the differences that exist between countries and the high costs to eliminate them [14]; local traditions exercise a strong influence over the implementations of new concepts (as previously noted on true and fair view) [29]; tax and legally-based orientation hinder the harmonization process [15, 34]; diversity will not disappear as it comes from different accounting cultures and their interpretation will be partly influenced by their history and previous practice [2, 13, 23, 24, 25, 33].

Several questions arise in this context: are transition countries, while their accounting models have understandably less tradition, more at ease to implement full IFRSs and the IFRS for SMEs? Are the differences between local practices and IFRSs more easily to be reduced? Previous studies show that even if some changes towards Substance over Form and a focus on investors have been tempted, the emphasis on compiling proper accounting records and on adhering to tax regulations rather than fairly presenting financial statements has continued in the Czech Republic [28, 29], and considerable differences between the Polish regulations and IFRS were identified given the legalistic and rule-based orientation of Polish rules [34]. Also, problems associated with lack of clarity in the fiscal law, a variable level of understanding of IFRSs by the regulators and preparers, the persistence of the communist mentality among accountants who gained their knowledge and skills prior the transition, the accountants’ preference for more prescriptive regulation and less choice of accounting treatments, were also documented [34].

Within the following text we will discuss the major differences between Czech accounting practices and the IFRS for SMEs. In general there could be stated, that there is commonly used the historical costs approach rather than fair value accounting [26, 27].

**Intangibles**

There could be stated that there are any significant differences from the measurement point of view. Like under IFRS for SMEs there are used costs upon initial recognition and costs less accumulated amortization and impairment losses upon balance sheet day. Useful life of intangibles in the Czech Republic is given by the Income Tax Act and there is expected that accounting unit will use the linear method of amortization. However under Czech legislation there are considered as intangibles incorporation expenses and research, which are not recognized as assets under international referential. The requirements on disclosed information are not specified in detail within Czech accounting legislature.

**Tangible Assets**

There could be stated that there are any significant differences from the measurement point of view for the category known under IFRS for SMEs as “Property, plant and equipment”. Like under IFRS for SMEs there are used costs upon initial recognition and costs less accumulated depreciation and impairment losses upon balance sheet day. The requirements on disclosed information are not specified in detail within Czech accounting legislature.

**Investment Properties**

Investment properties do not form a special category under Czech accounting regulation. Therefore there are used the very same rules for any other tangible assets. This leads to the recognition of the difference from IFRS for SMEs, where is applied the fair value approach. The requirements on disclosed information are not specified in detail within Czech accounting legislature.

**Leases**

There are any significant differences for reporting of operational leases. The treatment of financial leases is totally different when applying Czech and international rules. Under Czech accounting regulation there is not applied “substance-over-form” rule and it is the lessor who recognizes the object of financial lease and
depreciates it. Lessee is allowed just to post the rental payments as an expense of the period; however the rental payments have to be on straight-line basis due to the requirements of Income Tax Act. The requirements on disclosed information are not specified in detail within Czech accounting legislature.

Inventories
The treatment of inventories fully complies with IFRSs and there could not be seen any significant differences. However, the requirements on disclosed information are not specified in detail within Czech accounting legislature.

Financial Assets
Financial assets are measured upon initial recognition at cost. Upon balance sheet day there could be applied equity method or fair value approach for shares, and fair value approach for derivatives. Czech accounting however does not apply the amortized costs (or present values) as a measurement base. The division of bonds discounts or premiums shall be therefore straight-line based and the effective interest rate is not applied. The hedge accounting criteria are based on IAS 39 Financial instruments: recognition and measurement. The treatment of fair value hedge and cash flow hedge is very same like under “big set” of IFRS. The requirements on disclosed information are not specified in detail within Czech accounting legislature.

Receivables and Liabilities
Receivables and liabilities are measured at nominal values and it does not matter whether they are long- or short-term based. The amortized costs (or present values) as well as the effective interest rate are not applied. The deferred items are presented separately on balance sheet and not as a part of receivables or liabilities. Long-term receivables are reported as a part of current assets on balance sheet. The requirements on disclosed information are not specified in detail within Czech accounting legislature.

Provisions
Provisions are measured at nominal values. The time value of money is not applied upon Czech accounting legislature. The most popular provision in the Czech Republic, i.e. the provision on repair of tangible assets, is strictly prohibited under IFRS for SMEs. The requirements on disclosed information are not specified in detail within Czech accounting legislature.

3 Accounting Harmonization Measurement
Formal harmonization actually represents a first indispensable step in achieving material harmonization. Even though we accept the existence of alternative solutions and realities we believe that reaching the objective of financial reporting practices that are globally accepted requires an intermediate phase of harmonizing accounting regulations. Under these circumstances we consider that accounting harmonization represents a real process [30, 32] and seems to be essential in order to improve international comparability of financial statements, therefore increasing cash flows’ mobility and reducing costs in terms of financial statements’ preparation especially in the case of multinational companies [5, 7]. They consider that accounting harmonization assumes four essential aspects as follows: (1) the influences, (2) the process, (3) the result and (4) the consequences. The influences comprise those factors that have a certain impact on accounting practices’ harmonization. The process assumes the assembly of steps or efforts that are developed by companies in order to reduce existent differences of accounting practices. The result refers to the level of harmony being reached at a certain moment in time. Consequences refer to subsequent effects of the harmonization process.

It is therefore necessary to make the distinction between the two main types of harmonization that are de facto or material harmonization and de jure or formal harmonization. References with regard to the increase of the comparability degree are based on a high degree of conformity of accounting practices and afterwards on harmonizing regulations [4]. They also consider that formal harmonization usually generates or favors material harmonization without this representing the only solution. More precisely, material harmonization can develop without being generated through formal harmonization as its predecessor, through the so-called spontaneous harmonization. [30] also make a clear distinction between de jure harmonization and de facto harmonization. Through harmonization of accounting regulations (de jure harmonization) they analyze to what extent accounting standards and regulations are comparable. The latter concept (de facto harmonization) mostly analyzes to what extent accounting regulations are found within companies accounting practices [20]. [31, 32] also distinguish spontaneous harmonization besides formal harmonization and material harmonization. Furthermore, spontaneous harmonization represents
a subcategory or a particular form of material harmonization [21]. The approach in accordance to which material harmonization can be reached without first going through formal harmonization is also argued by [32].

We can say that two main forces are involved within the international accounting harmonization process: (1) institutional efforts for international accounting harmonization through the development of common accounting rules and standards and (2) spontaneous efforts of global players in order to adopt accounting methods that should improve their communication with accounting information’s users in other countries [4]. This two forces act simultaneously, consolidating each other, but in some cases acting independently under the umbrella of the globalization phenomenon.

Spontaneous accounting harmonization can be considered as a deviation from or alternative to the natural/classical evolution of the accounting harmonization process. Such a deviation incurs when some deficiencies characterize the process of harmonizing regulations or when the pace of this harmonization process does not correspond to financial reporting’s need for comparability as expressed through accounting practices and realities. In other words we can consider that spontaneous harmonization is a reaction of response to the need for accounting harmonization coming from accounting practice. Spontaneous accounting harmonization therefore develops due to forces of the market and not to accounting regulations [21] and their harmonization.

We can observe that instruments measuring the compatibility degree of accounting practices and of different sets of accounting regulation actually record a convergent time evolution towards the common point given through measurement instruments based on similarity. Moreover, a clearer dimensioning of the accounting harmonization degree is obtained when using either association coefficients (Jaccard’s Coefficients, Roger-Tanimoto Coefficient, Lance-Williams Coefficient), either correlation coefficients (Pearson Coefficient, Spearman Coefficient).

We will discuss now the compatibility levels between all sets of national harmonization with international referential. For the compatibility calculation were used Jaccard’s coefficients (for measurement of similarities and dissimilarities), Roger-Tanimoto coefficient (for measurement of similarities) and Lance-Williams coefficient (for measurement of dissimilarities).

All sets of accounting regulations were tested within 8 particular areas: (i) intangible assets, (ii) PPE, (iii) investment properties, (iv) financial leases, (v) inventories, (vi) financial assets and liabilities, (vii) financial derivatives, and (viii) financial statements. Discussed issues are part of Appendix. Tables 1 and 2 provides evidence about measurement of similarity and dissimilarity level between all accounting regulations (Czech, IFRS, IFRS for SMEs).

Table 1. Similarity Analysis between Czech System and IFRSs

<table>
<thead>
<tr>
<th>System</th>
<th>CZE</th>
<th>IFRS</th>
<th>SME</th>
</tr>
</thead>
<tbody>
<tr>
<td>CZE JC</td>
<td>1.0000</td>
<td>0.5455</td>
<td>0.5667</td>
</tr>
<tr>
<td>RT</td>
<td>1.0000</td>
<td>0.3750</td>
<td>0.4348</td>
</tr>
<tr>
<td>IFRS JC</td>
<td>0.5455</td>
<td>1.0000</td>
<td>0.8621</td>
</tr>
<tr>
<td>RT</td>
<td>0.3750</td>
<td>1.0000</td>
<td>0.7838</td>
</tr>
<tr>
<td>IFRS/SME JC</td>
<td>0.5667</td>
<td>0.8621</td>
<td>1.0000</td>
</tr>
<tr>
<td>RT</td>
<td>0.4348</td>
<td>0.7838</td>
<td>1.0000</td>
</tr>
</tbody>
</table>

Source: own analysis

Table 2. Dissimilarity Analysis between Czech System and IFRSs

<table>
<thead>
<tr>
<th>System</th>
<th>CZE</th>
<th>IFRS</th>
<th>SME</th>
</tr>
</thead>
<tbody>
<tr>
<td>CZE JC</td>
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<td>0.4333</td>
</tr>
<tr>
<td>LW</td>
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<td>0.2941</td>
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</tr>
<tr>
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<td>0.0000</td>
<td>0.1379</td>
</tr>
<tr>
<td>LW</td>
<td>0.2941</td>
<td>0.0000</td>
<td>0.0741</td>
</tr>
<tr>
<td>IFRS/SME JC</td>
<td>0.4333</td>
<td>0.1379</td>
<td>0.0000</td>
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<tr>
<td>LW</td>
<td>0.2766</td>
<td>0.0741</td>
<td>0.0000</td>
</tr>
</tbody>
</table>

Source: own analysis

Results proof the close linkage between big set of IFRS with separate standard IFRS for SMEs. Czech accounting system is slightly closer to IFRS for SMEs, however there shall be pointed out the major differences as follows:

- facultative preparation of Cash Flow Statement and Statement of Changes in Equity under Czech accounting system,
- application of “form-over-substance” for financial leases treatment in Czech
- much lower level of disclosure.

4 Conclusion

IFRS information can help SMEs involved in buying or selling goods or services across national borders to initiate new relationships with customers and suppliers. As the spread and acceptance of IFRS grows internationally, so does the importance of IFRS financial statements as a tool to cultivate a positive image. It is not only large foreign groups that now demand financial statements from SMEs as
part of the process of supplier selection and evaluation.

Strength of SMEs (small and smaller medium enterprises in particular) consists in their higher flexibility and to a certain point also in their innovative creativity. The standard offers an opportunity for entities without public accountability to adopt a reporting framework that may lighten their reporting burden, if permitted by local regulation. Furthermore, it could facilitate an internationally recognized common reporting language for entities that meet the definition of an SME as set out in the standard.

Having financial information that is universally understood and comparable to other companies’ information can improve relationships with customers, suppliers, investors and bankers. If these business partners have more confidence in the financial information being provided using IFRS, this can be a crucial factor in securing a new supplier, obtaining finance, reducing the cost of borrowing, and arriving at an acquisition or cooperation agreement.

Adoption of IFRS for SMEs could be vital for true-and-fair view and for the higher comparability of accounting information in globalized world. The crucial necessity will be the wider spread of IFRS for SMEs knowledge. Generally, IFRS for SMEs is based on different concept than continental accounting regulation, so it’ll be not only about the training of new accounting regulation, but about the training of the different accounting thinking and different approach for posting of accounting transaction. There will be also necessary to provide regular information for professional accountants about the evolution and changes in IFRS for SMEs and the long-life training.

As a possible limit for the current adoption of IFRS for SMEs could be considered the lack of motivation as the clients of professional accountants prefer rather than true-and-fair view the best solution of accounting operation from the tax point of view, due to the close connection of national accounting systems to tax regulation.

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