

Changes in Accounting Regulation in the Czech Republic over past twenty five years

Marcela Žárová¹

¹ University of Economics, Prague
Faculty of Finance and Accounting, Department of Financial Accounting and Auditing
W. Churchill Sq. 4, 130 67 Prague 3, Czech Republic
E-mail: zaroval@vse.cz

Abstract: There is a change in regulatory approaches in accounting over last two decades. The change has been caused when IFRS has been introduced into European scene since 2005. Situation radically altered not only for listed companies in Europe. The regulation which went into effect in 2005 had a strong influence on the way of accounting regulation in general. Because of the IFRS introduction into the European regulatory systems, especially into Continental European ones, there would be expected introduction of professional accounting bodies into the process of standard settings. Objective of this paper is to investigate changes in accounting regulation process in the Czech Republic.

Keywords: IFRS, accounting regulation, accounting standards

JEL codes: M41

1 Introduction

The Czech Republic, as continental European country, belongs into the Continental model of accounting regulation which is characterized by a larger role given to the legislation in accounting regulation (Nobes and Parker 2012). Financial reporting in such system, regulated by law, is too detailed on one hand and on the other hand most legislators are not well informed about accounting concepts and technicalities of financial reporting. There is a danger that provisions of the law will be inappropriate. This seems to be the greatest disadvantage of the Continental model. At second the stock exchange is less important, companies obtain majority of their funds from banks and other financial institutions. Bromwich and Hopwood (1992) note that legislators never give priority to laws concerning financial reporting and therefore laws are often enacted after considerable delays by the time they come into force and they are nearly out of date. Therefore law does not seem to be effective way of dealing with urgent problems or with new topics or development in financial reporting. Is there any change in regulatory approaches over last two decades when IFRS has been introduced into European scene since 2005? As Véron (2007) notes, situation radically altered for listed companies in Europe. The regulation which went into effect in 2005 mandates consolidated group reporting by companies with securities traded on a stock exchange to adhere IFRS as issued by IASB and endorsed by the EU. Because of the IFRS introduction into the Continental European regulatory systems, there would be expected introduction of professional accounting bodies into the process of standard settings.

Accounting regulation in the Czech Republic is represented by the system where the Accounting Act is on the top of the regulatory hierarchy and it is supplemented and completed by a number of other rules, issued by the same institution of the government that provides the Act. The natural consequence of these facts is that financial statements play a less important role in providing information for investors, as providers of debt finance and venture capital are generally able to obtain all information that they need through direct contacts with the company's management. Assumption concerning impact of IASB and IFRS on local regulator that the role of professional institutions would be enlarged hasn't been fulfilled in the Czech Republic. Moreover the process of standard

settings that is restricted to the governmental body only shows tendency to be considerably delayed by the time and without feedback from real life.

Situation where local accounting regulation is shared between governmental regulatory body and the private professional accounting one become standard in Europe. This standard situation rather differs from the case of the Czech Republic, where government not even delegate private professional accounting body to prepare accounting standards but professional accounting body in addition replaces work of accounting regulator. Uniqueness of the situation in the Czech Republic is caused by the fact that professional accounting body is represented by tax advisors from one quarter of members.

2 Methodology and Data

Accounting research offers two approaches for accounting regulation as it is stated in Dennis (2014) and Di Pietra, McLeay and Ronen (2014). According to the first approach, accounting information acquires regulatory significance, to the extent that it imposes and stimulates management behaviors within company. Regulation is seen as affecting management behaviour at both strategic and operational levels of management, and is influenced by the specific characteristics of corporate governance in a given company. While the second approach focuses on models that determine the regulation of accounting procedures which companies are called upon to perform. This approach focuses on accounting information in their search for appropriate solutions to improve models of regulation in place at national and international levels (i.e. their efficacy and efficiency). This approach also considers the nature and quality of the accounting information that is produced and disseminated within different regulatory frameworks. There are at least three subsections of research in accounting regulation. The following areas of investigation, among others, are to be identified a) theories on the evolution of accounting rules could be referred, amongst others, to the contributions of Watts and Zimmerman (1987), Bronwich (1985), Horngren (1985); b) regulatory instruments that enable the enforcement of accounting rules and the role of institutions that represent interests gained through regulatory privileges. On the instruments to be adopted to stipulate the application of accounting rules Benston (1980), Jönsson (1991), Mitchell and Sikka (1993); c) the application of political pressure on bodies issuing accounting rules, through lobbying and related forms of influence Walker and Robinson (1993, 1994), Klumpes (1994). Accounting interacts with the forces of economics and politics, guiding strategic decisions made in both national and, increasingly, international context. Here, in this paper, accounting regulation is meant as the process of law making and accounting standard setting by government and institutions operated in profession within a specific national context. A new phenomenon that appears in regulatory systems over last years, presented by Smidt and Kirschner (2005) concerning the role of accounting standards in continental European systems. Researchers focus on situation where in the Continental regulation system two different standard setters appear, governmental and private ones and started to use label hybrid regulatory system for this special organization of regulation. Königsgruber (2007) confirm that in addition to private-sector standard setters, a number of public actors are involved in accounting standard setting. Accounting standard setters have often been criticized for giving undue influence to individual, most corporate, actors and being subject to regulatory capture.

While in developed countries, research on accounting regulation identifies fear of too much political interference preventing "objective" accounting standards. Situation is reversed in the Czech Republic. Königsgruber (2007) says: "Major international accounting standard setters follow a due process approach giving companies the ability to express their view and have them taken into account. However, managers generally do not wish to express their preferences in full view of the investing public. Instead, they may use good personal contact to political decision-makers in order to gain leverage over the standard setter.

Little research has been done in the Czech Republic directly toward regulation. Research that has been carried out has mainly focused on influence of IFRS on financial reporting.

Procházka (2015) prepared an overview of research studies in transitive economies and confirm that majority of research studies concentrate on IFRS implementation. Reasons for this situation see as consequences of lower level of GDP in absolute value or GDP per capita, with the exception in Poland.

The research is designed as a holistic single-case study, defined by Yi (2013) as a single-case study with a single unit of analysis. The case is development of regulatory accounting system in the Czech Republic.

3 Results and Discussion

In May, 2004, the Czech Republic joined the European Union (EU). Becoming a member of the EU has been crucial to speeding up reform of the Czech accounting system. As a member, the Czech Republic is committed to requiring its listed companies to comply with international financial reporting standards in their consolidated financial statements at least. The Czech accounting system demonstrates the consequences of the European Commission's decision to apply the IFRS at the national level. Fundamental changes were incorporated into the Act since 2004. The amended Act incorporates implementation of IFRS as required under European Union regulation. Use of IFRS has become obligatory for consolidated accounts of publicly traded companies since May 1, 2004. Requirements of the 2002 Regulation on the application of IFRS has been extended to annual accounts of publicly traded companies if their securities are admitted to trading on an EC regulated market in the Czech Republic. Cash based accounting for general business enterprises was eliminated from the Act and became part of tax evidence under the tax law. An obligatory simplified accounting approach has been introduced for small entities (under specified conditions).

While the Accounting Act that set out the general principles to be applied remained unchanged since July 1, 1994, the Chart of Accounts and the detailed guidance notes on the Accounting Procedures for Business were subject to many minor amendments that went into effect at various times from 1994 to 2002. Despite the amendments, obstacles in changing the primary purpose of the financial statements still existed in the new accounting environment (e.g. from tax oriented accounting to the means by which owners and management measure the financial position and performance of the business). The EC adopted a communication in June 2000, which proposed that all listed companies prepare their consolidated financial statements in accordance with IASC standards by 2005 at the latest. Adoption of the 2002 EU Regulation on the application of IFRS also had fundamental effects on further development of accounting in the Czech Republic. Changes in the system of accounting rules were completed as of January 1, 2004. Regulatory guidance for accounting was replaced by a new phenomenon in the Czech accounting, Czech Accounting Standards. Czech Accounting Standards were introduced by the legislator into the Act on accounting and came into force since 2004.

Three levels of accounting regulations have been in force since beginning of 2004 and it is demonstrated in Table 1.

Table 1 Three-level accounting regulation

Three-level accounting regulation	
Rule	Rule-making body
Accounting Act	Ministry of Finance
Decreases	Ministry of Finance
Czech Accounting Standards	Ministry of Finance OR Independent Professional Institute

Source: McGee, R. W. et al. (2008): Accounting Reform in Transition and Developing Economics, own illustration

There is a separate article in the Act determining who is allowed to develop Czech Accounting Standards. The article determines Ministry of Finance or any legal entity

selected in public tender. This is historically the first moment when Ministry of Finance admits the possibility of existence a rule-making body that differs from Ministry of Finance. This provision has never been implemented in practice and the entire accounting regulation has thus been prepared by the Ministry of Finance (Ištvánfyová et al, 2010). Existence of the rule-making body that differs from Ministry of Finance opens the possibility to develop hybrid regulatory accounting system. Hybrid regulatory accounting system was introduced by Kirchner, Ch., and Schmidt, M. (2006) for German regulatory accounting system, where two standard setting bodies exist in the regulatory system: Ministry of Justice and German Accounting standards Board (DSR). Based on this approach, Žárová (1997) subdivided hybrid regulatory accounting system into primary and secondary one. According to Žárová (1997), situation in Germany would be described as primary hybrid regulatory system as there are two different standards setting bodies exist. Secondary hybrid regulatory accounting system is characterized by existing of two different types of instruments regulating accounting: firstly, regulation is realized by act in all levels of the hierarchy and secondly regulation is realized by IFRS. EC regulation that introduced IFRS into all European accounting systems caused secondary regulatory hybrid system for all domestic regulatory systems of accounting in all EU member countries regardless the law system.

Ministry of Finance introduced Czech Accounting Standards into existence, which don't represent the "best practice" as it is usual from accounting regulatory systems, where private accounting body prepare standards. Standards should contain a description of the accounting methods or procedures. The content of the standards may not be inconsistent with the provisions of the Act on Accounting and other statutory provisions or circumvent their purposes. The application of standards by accounting entities shall be regarded as compliance with the provisions on accounting methods pursuant to the Act. The rules for the development and issue of the standards may be specified by Ministry of Finance in implementing statutory provisions. The issue of the standards shall be promulgated in the Financial Bulletin. Ministry of Finance shall keep a register of the standards issued. No public tender was announced till the end of 2003 and therefore Czech Accounting Standards were prepared and issued by Ministry of Finance exclusively.

Czech accounting standards are an integral part of the three levels of accounting regulation. Czech accounting standards do not represent the best practice as they are standards only by name. Standards are issued by the accounting regulator, the Ministry of Finance. They are not developed under due process, where organizations or individuals submit their suggestions. Standards are prepared separately for different accounting entities and determine admissible accounting method or procedures.

Despite the fact that after 1989, professional chambers in accounting and auditing were established, the influence of these chambers on the regulation of accounting was practically zero, the communication with the regulator were limited to scarce cases of commentary procedure. Professional chambers were established on the basis of special laws which are independent on the State and operate as self-governing regulatory bodies of the individual professions. However, the first years of their existence (approx. until 1997) were focused on the conditions of entry into the given professions (organisation of examinations), position of their members, powers of the self-governing bodies towards the members (work of supervisory and disciplinary commissions) and, possibly, on strengthening the position of the profession in relation to the State administration. These professional organizations worked relatively independently and separately on these tasks and the coordination of joint action was very low. The influence of Professional chambers were ignored in the process of preparing accounting standards or other governmental rules and weren't nominated as official commentary place in the legislation process so it was always considered to be a great success if the prepared standard was even "submitted" for commentary procedure.

The influence of professional organizations and the academic environment in the area of accounting on the form of legal regulation of accounting or, possibly, its contribution to creating standards for practical procedures in bookkeeping was very low and differs

significantly from the Anglo-American system of regulation of accounting where the national regulator of accounting verifies the professional institutions by creating accounting regulations, mostly in the form of standards. Nobes and Parker (2014) or Flower and Ebberts (2002) note that there are distinguished between an Anglo-American and a Continental model of accounting regulation. Whereas the US has a long tradition of standard setting by an organism belonging to the private sector (Zeff 2005), Continental European countries are characterized by a larger role given to legislation in accounting regulation. This gives companies and managers opportunity to participate in standard setting process. Another interesting aspect of standard setting process is a participation of academics in this process. As McLeay et al. (2000) note, there is traditionally high involvement by accounting academics in Germany, while few academics participate in the standard setting process in the US by submitting comment letters (Tandy and Wilburn 1996).

Systematic research of accounting regulatory systems over last decade brings us suddenly different view. It starts to be complicated to find regulatory system clearly and reliably determinable in compliance with traditionally known characteristics. Over last decade, instruments of regulatory systems of accounting are changed and institutions developing standards are changed as well as. Instruments of regulatory systems of accounting are mostly combination of elements of private and public standards setting even in those regulatory systems of accounting where this tradition does not exist. Institutions developing accounting standards are traditionally independent professional accounting bodies, nowadays governmental agencies becomes standard setters and developed quasi standards. These regulatory systems of accounting, where accounting system combines elements of private and public standards setting and independent professional accounting bodies with governmental institutions could be called hybrid regulatory ones.

In late nineties neither professional chambers nor academics in the Czech Republic have even possibility to participate in standard setting process. Unsurprisingly, given the overall frustration over the mechanism of making comments on the legal regulations in the area of accounting prepared by the Ministry of Finance which was mostly redundant and ineffective due to fragmentation into the mentioned professional organisations and academic environment, there was an agreement during the preparation of the first fundamental post-revolutionary amendment to the Accounting Act between all professional organisations and the University of Economics in Prague on the joint action in the preparation of and making comments on the amendment of Act (Mejzlík, 2008). The institutional result of this agreement consisted in establishing the Czech National Accounting Board (hereinafter the "CNAB") on 18 January 1999 as a special-interest association of legal entities. Three professional organizations together with academics established one professional body; in 1999 an independent national accounting body - the Czech National Accounting Board - was established (CNAB). Board was established by the initiative of Czech accountants, the Chamber of Auditors, Faculty of Finance and Accounting at the University of Economics in Prague, and the Chamber of Tax Advisors. This was the reason to establish an institution unifying their common effort to enforce the accountancy profession in the Czech Republic, the CNAB. Board is an independent professional organization to support professional eligibility and professional ethics contributing accountancy profession, methodology of accountancy and financing.

The main aim of the CNAB is to support the development of accountancy toward an independent respected profession in the Czech Republic, to have a complete responsibility for preparation and issuing Interpretations to Czech Accounting Standards (CAS) and to participate in the process of issuing Czech Accounting Standards (CAS) in order to be developed through a formal system of due process.

The CNAB is fully responsible for preparation and issuing Interpretations to Czech Accounting Standards (CAS). Standard setting process, where there is an absence of correction from public, suffers from defectiveness in different aspects. In such regulatory system, absence of best practice is one of those aspects. Naturally developed best

practice has no place in continental European accounting systems and very poor tradition in rigidly ruled accounting systems. Absence of best practice is slowly replaced by the systematic identification of issues to be on agenda of the Czech National Accounting Board and development of Interpretations. Some interpretations were issued as an operative solution of accounting treatment. Other interpretations are faced with conflict between accounting treatment in a Decree or Czech accounting standards and the requirement of true & fair view in Law on Accounting. In that case, where there is a conflict between accounting treatment in a Decree and true & fair view requirement, absence of conceptual framework is especially serious matter.

4 Conclusions

Situation where local accounting regulation is shared between governmental regulatory body and the private professional accounting one become standard in Europe. Assumption concerning impact of IASB and IFRS on local regulator that the role of professional institutions would be enlarged hasn't been fulfilled in the Czech Republic.

Accounting regulation in the Czech Republic is represented by the system where the Accounting Act is on the top of the regulatory hierarchy and it is supplemented and completed by a number of other rules, issued by the same institution of the government that provides the Act. The natural consequence of these facts is that financial statements play a less important role in providing information for stakeholders.

As the process of standard setting in the Czech Republic is restricted to the governmental body only standard setting process shows tendency to be considerably delay by the time and without feedback from real economic life. This situation was evident to representatives of professional bodies in accounting, auditing and taxation in the Czech Republic. This was a reason that brought different professional institutions together and established the Czech National Accounting Board. The aim was that Board become a professionally strong partner for communication with the Ministry of Finance. The original ambitious intention of the Board that the CNAB will be appointed by the Ministry of Finance in the Czech Republic with creating the Czech accounting standards as permitted by the Accounting Act has not been fulfilled yet. As the CNAB is as an association of professional chambers with a view to promoting professional qualification and professional ethics in the development of accounting professions and methodology of the Czech accounting it strives to fulfill the mission. That was the reason why the CNAB members decided in 2004 that it would be appropriate to assist the Czech accounting public by publishing interpretations of the Czech accounting regulations.

Interpretations of the Czech National Accounting Board consider accounting issues in the Czech legislation that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance. The work of the CNAB has an impact on the accounting profession and accounting entities in that a number of them are in practice inspired by or follow the published Interpretations which represent a professional opinion based on high professional prestige of all the CNAB members.

Despite the fact that professional accounting body is not introduced into the process of standard settings in the Czech Republic, this body became respected authority by accounting public.

Acknowledgments

"This paper has been prepared under financial support of research projects IP100040".

References

- Benston, G. J. (1980). The establishment and enforcement of accounting standards: Methods, benefits and costs. *Accounting and Business Research*, 11, 51-60.
- Bromwich, M. (1985). *The economics of accounting standards setting*. Hemel Hempstead: Prentice-Hall.

- Bromwich, M., Hopwood, A. (1992). *Accounting and Law*. London. Prentice-Hall.
- Dennis, I. (2014). *The nature of accounting regulation*. New York. Routledge
- Di Pietra, R., McLeay, S., Ronen, J. (2014). *Accounting and regulation. New insight on governance, markets and institutions*. New York. Springer.
- Flower, J., & Ebbers, G. (2002). *Global Financial Reporting*, Basingstoke: Palgrave.
- Horngren C. T. (1985). Institutional alternatives for regulative financial reporting. *Journal of Comparative Business and Capital Market Law*, 7, 267-289.
- Ištvánfyová, J., Mejzlík, L., & Pelák, J. (2010). Progression of Financial Reporting in Czech Republic and its Regulation. *European Financial and Accounting Journal*, 2010, 5, 64-77.
- Jönsson, S. (1991). Role making for accounting while the state is watching. *Accounting, Organizations and Society*, 16(5), 521-546.
- Kirchner, Ch., Schmidt, M.,: IFRS and EU accounting regulation – problem of hybrid standard setting, EAA Congress paper, Dublin 2006
- Klumpes, P. J. (1994). The politics of rule development: A case study of Australian pension fund accounting rule-making. *Abacus*, 30, 140-159.
- Königsgruber, R. (2007). Accounting Standard Setting in Two Political Contexts. In *Accounting and Regulation* (pp. 59-78). Springer New York.
- Mejzlík, L. (2008). Národní účetní rada a její interpretace českých účetních předpisů. [National Accounting Board and its interpretations of Czech accounting regulations.] *Bulletin Komory daňových poradců*. 16, 29-35.
- Mitchell, A., & Sikka, P. (1993). Accounting for change: Institutions of accountancy. *Critical perspective on Accounting*, 4, 29-52.
- McLeay, S., Ordelheide, D., & Young, S. (2000). Constituent lobbying and its impact on the development of financial reporting regulations: evidence from Germany. *Accounting, Organizations and Society*, 25, 79-98.
- Nobes, Ch., Parker R. (2012). *Comparative International Accounting 12th Edition*. Pearson.
- Procházka, D. (2015). Ekonomické dopady implementace IFRS v Evropě. [Economic impact of IFRS implementation]. Praha: Vysoká škola ekonomická – Oeconomica, 154
- Schmidt, M., & Kirchner C. (2005). Private Law-Making: IFRS – Problems of Hybrid Standard Setting, in: Peter Nobel, Hg., *International Standards and the Law*, Berne: Stämpfli, 67-82.
- Tandy, P. R., & Wilburn, N. L. (1996). The academic community's participation in standard setting: Submission of comment letters on SFAS nos. 1-117. *Accounting Horizons*, 10, 92.
- Veron, N. (2007). *The Global Accounting Experiment*. Bruegel blueprint series, Volume 2, 2007.
- Yin, Robert K. (2013). *Case study research: Design and methods*. Sage publications.
- Walker, R. G., & Robinson, P. (1993). A critical assessment of the literature on political activity and accounting regulation. *Research in Accounting regulation*, 7(1), 3-40.
- Walker, R. G., & Robinson, S. P. (1994). Competing regulatory agencies with conflicting agendas: setting standards for cash flow reporting in Australia. *Abacus*, 30(2), 119-139.
- Watts, R. L., & Zimmerman, J. L. (1978). Towards a positive theory of the determination of accounting standards. *Accounting review*, 112-134.
- Zeff, S. A. (2005). The evolution of US GAAP: the political forces behind professional standards. *The CPA Journal*, 75(2), 18.
- Žárová, M. (2007). Analysis of Hybrid Regulatory Accounting Systems. *European Financial and Accounting Journal*. 2, 8-25.