

# CHANGING IMPLEMENTATION OF IFRS IN CZECH SMES: LONGITUDINAL STUDY

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## Abstract

An increasing number of Czech SMEs are using the IFRS standards for reporting purposes. Their most frequently cited motivation is the requirement of a foreign parent firm to use the IFRS for consolidation purposes. It would seem that the Czech companies could simply follow the way, however, the situation is not so straight forward. This study examines the macroeconomic context and related legal and institutional issues of the IFRS implementation as rooted in the Central European institutional background. Based on a questionnaire survey conducted periodically four times over six years, we attempt to identify the effects of IFRS adoption connected with the SMEs context. The paper finds that, even though the pressure to use the IFRS is rising, important institutional factors and constraints on the side of the users, in terms of a lack of perceived benefits complicate the way of IFRS usage for the majority of Czech SMEs. Also, the preparedness of accounting professionals is quite low, as well as the benefits attributed to the IFRS adoption by SMEs' executives. Furthermore, the Ministry of Finance only gradually adapts to special features of the Czech environment and only recently makes the transition to IFRS less strictly regulated.

**Key words:** IFRS, Institutional factors, Legal factors, SMEs.

**JEL Code:** M 41, M21, F65

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## Introduction

An increasing number of Czech SMEs now uses the IFRS standards for reporting purposes. IFRS are designed to report about the business processes for the purposes of decision making by current and potential investors - This information, however, does not meet the needs of other users, such as managers, business partners and creditors. Different needs of accounting data in the sector of SMEs users have led to the creation of a simplified set of IFRS standards. The frequently cited reason for IFRS use in Czech companies is usually the increase in foreign ownership or a close trade relationship to an international company, which needs to report

according to IFRS for consolidation purposes (Procházka, 2012 and 2017; Zarova and Mejzlik, 2009; Jindrichovska and Kubickova, 2014 and 2016).

The expected effects of the IFRS application in the SMEs segment shifted from investors decision-making and increased operations in capital markets to other areas, where the process of globalization is reflected - business links that reach beyond national boundaries (a) relations with foreign suppliers (b) acquisition of new clients and markets abroad. This aspect has become more important, especially in the matter of comparability and transparency of accounting data in order to monitor the financial situation of partners and competitors. The development of these contacts is limited by differences in the commercial tax and other legislation, and by differences in the provided financial information. And so the existence of a single set of financial reporting standards (IFRS) is a good solution for these purposes.

International business contacts can thus be assessed in close relation to development of economic system as a whole, which is represented by indicators such as Foreign trade, Foreign direct investment, Balance of statements and GDP Growth. This study examines the macroeconomic context and related issues of IFRS implementation in Czech SMEs as rooted in the Central European environmental and institutional setting, and summarizes the results of empirical research exercised over a time-frame of six years. The paper finds that, in spite of rising pressure to use the IFRS, important institutional factors and various prejudices and limited perceived benefits complicate the way for the majority of Czech SMEs. Moreover, the general economic background is changing and getting more standardized. The Czech legislative environment is incorporating more features from the harmonizing and integrating European legislature (Pelikánová, 2013), or the EU Accounting Directive 2013/34/EU (Jindrichovska, & Kubickova 2017). Nevertheless, some stakeholders have adapted to recent changes of accounting administrations slowly. The Czech Ministry of Finance does not speed up implementation of new standards, therefore the international companies provide pressure on IFRS implementation in their own manner. According to our investigation, the IFRS reporting was used in about one quarter of Czech firms in 2016.

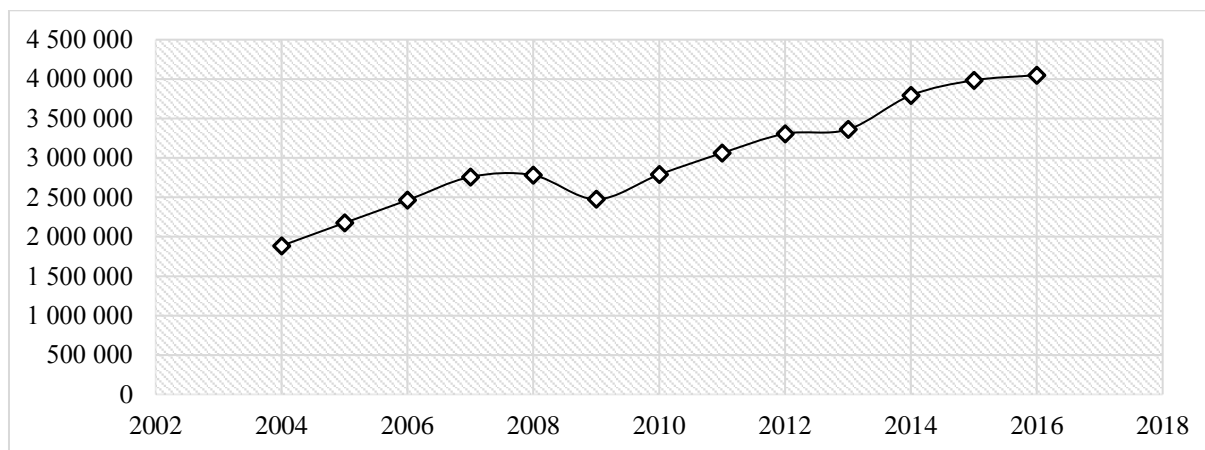
In our study, we attempt to verify if the implementation processes of IFRS are in relation to the development of selected macroeconomic indicators. The implementation process of IFRS is not based on the needs of capital market investors but rather on requirements of individual firms in connection with their business strategy and policy – frequently the expansion of their business links to foreign stakeholders and markets. The method of the preparation of the financial statements for these purposes is not regulated by national legislation. However, the

application of IFRS establishes a duty - as for all entities defined by the Accounting Act - to keep accounts according to Czech accounting standards, and to compile the financial statements according to Czech accounting standards for the purposes of a tax base calculation. Exceptions are the subsidiaries of foreign companies that report to their parent company according to IFRS. Here, the company can prepare financial statements primarily according to IFRS (in accordance to the Decree of May 2011). But, they are still obliged to calculate the tax base according to Czech accounting standards. In a case where a company wants to take the advantage of the financial statements in accordance with IFRS, they have to compile and prepare two sets of financial statements.

## 1 Changing macroeconomic background

The Czech Republic is characterized as a small open economy with a large export sector. The balance of payments has been positive during recent decades, which confirms to the trend of an industrial country with a long tradition of industrial production. The economy returned to the growth after the financial crisis in 2014, after a repeated moderate slowdown in 2011.

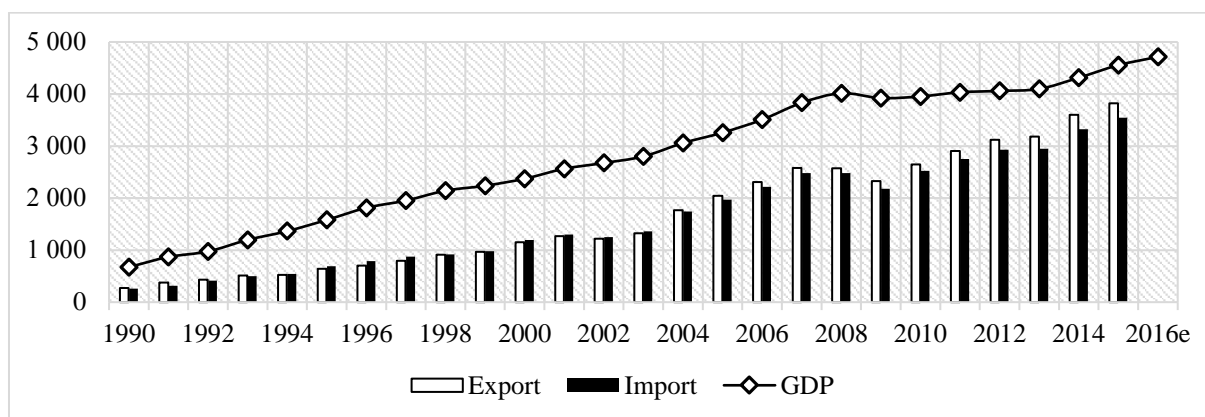
**Fig. 1: Balance of payment (current account) in mil. CZK**



Source: <https://www.cnb.cz/analytics>

Czech international trade is diversified, but the main export sectors remain machinery and transportation industries. The Ministry of trade and industry strives to increase the volume of trade and increase its diversity by removing barriers to trade, simplification of access to information and government missions. As a result, the Czech export totals have been growing in recent years, especially after the crisis that culminated in 2009, which was caused mainly by the unfavourable global situation. The full growth started in 2014.

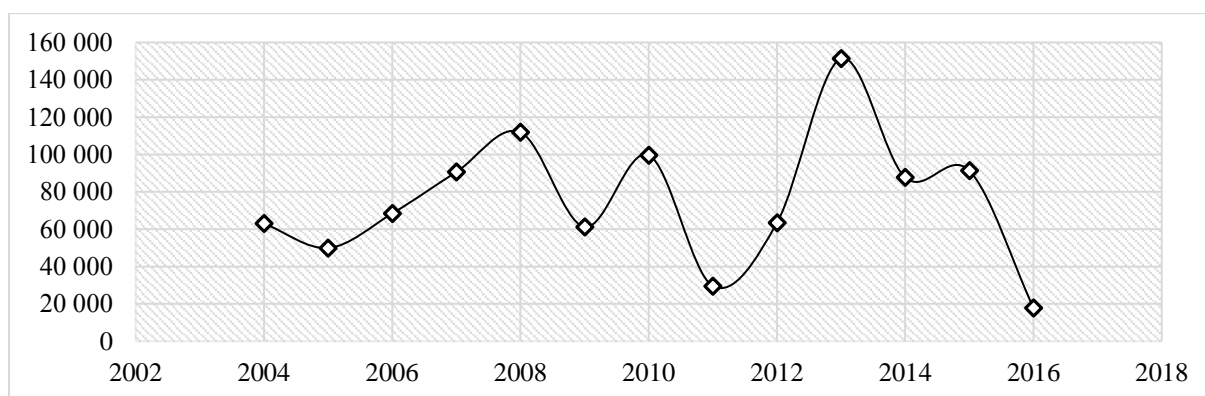
**Fig. 2: GDP, Export, Import in bil. CZK**



Source: <https://vdb.czso.cz/>

This graph shows how is the general growth of GDP supported by the country's exports. Another measure of the quality of a macroeconomic environment is frequently a characteristic for countries attractiveness as to the Foreign Direct investment.

**Fig. 3: Direct Investments in mil. CZK**



Source: <https://www.cnb.cz/en/statistics/>

FDIs have been important for the economy in late 1990s. Nowadays, their importance has been reversed, as foreign companies repatriate their profits earned and less money remains in the Czech Republic. Nevertheless the volume of FDIs reacts not only to perceived economic stability and country's but also to quality of the business environment, characterized by the Business environment ranking, where the Czech Republic is at 28th position. As to Czech capital market. The Prague Stock Exchange was re-opened in 1993, however its function is not

significant, there have been fewer than ten IPOs since the restart. Now it is a part of the stock exchange group CEESEG AG, domiciled in Vienna.

## 2 Empirical analysis and findings

### 2.1 Motives of investigation

The aim of the longitudinal research was to determine at what stage, and to what extent is the need for comparable financial information part of the business environment of Czech SMEs: how intense is the need, and what positive effects do the managers perceive by its adoption. The research was carried out from 2009 to 2016. The first two projects were carried as projects from the grant agency of VSFS Prague, one in collaboration with FAME TBU Zlín as a part of the GAČR project in years 2009-11, and the last was carried out in cooperation with the AAU Prague. All projects focussed especially on the extent and expected benefits of IFRS application in the use of IFRS in SMEs. Research methodology was based on the questionnaire pool. Respondents were employees of randomly selected companies - most of them were representatives of medium and top management. Some of the respondents were companies' owners. The samples of companies were similar as for the sectors, categories of SMEs (micro, small and medium-sized enterprises). A little difference was in the region – the first sample used respondents mostly from central Moravia, while in the following cases the respondents were from central Bohemia. Sample characteristics are presented in table 1.

**Tab. 1: Samples characteristics**

Research project	Number of Respondents	Industrial sector ( <i>in %</i> )		
		Production	Trade	Services
Project GAČR UTB Zlín +VSFS(2009-10)	89	37	28	35
Project IGA VŠFS(2010-11)	120	31	31	38
Project IGA VŠFS(2012-13)	102	43	22	35
Project IGA VŠFS+ AAU (2014-15)	258	160	42	56

*Source: own research*

### 2.3 Empirical results

The investigations focused on a few areas that characterise the place of IFRS in SMEs' activities. The first part investigates whether SMEs that prepare their financial statements use other standards than the Czech accounting standards (CAS), and the intensity of SMEs contacts with foreign partners. The number (and the percentage proportion) of companies using another system than (CAS) are presented in table 2.

**Tab. 2: Preparing financial statements – usages of IFRS and other standards**

	<b>Only CAS</b>	<b>CAS+IFRS</b>	<b>CAS+US GAAP</b>	<b>CAS+other GAAP</b>	<b>Only IFRS</b>	<b>Total</b>
	<i>% (abs.)</i>	<i>% (abs.)</i>	<i>% (abs.)</i>	<i>% (abs.)</i>	<i>% (abs.)</i>	
Project GAČR Zlín+VSFS(2009-10)	90%(80)	6%(5)	1%(1)	3%(3)	-	89
Project IGA VŠFS (2010-11)	84%(101)	10%(12)	3%(3)	1%(1)	3%(3)	120
Project IGA VŠFS (2012-13)	73%(75)	18%(18)	6%(6)	3%(3)	-	102
Project IGA VŠFS+AAU (2014-15)	66% (169)	27 % (70)	4% (10)	3% (9)	-	258

Sources: own research

The results of the investigation show that the business contacts with foreign suppliers, customers, and parents have been present in more than half of the companies (57 to 58 per cent) in all four instances. The link to a foreign supplier was the most significant and frequent (this proportion has gradually increased from 28 to 72 per cent). The proportion of links to foreign customers has been somewhat lower in all instances, although it was also increasing. Contacts with a parent company show a similar rising pattern: from 20 to 31 per cent.

In the following stage of investigations, the nature of contacts changed. Results demonstrate gradual expansion of foreign business contacts of SMEs. The same company can have a link to a parent company plus to a foreign supplier or customer the main proportion show contacts with the foreign suppliers - see table 3.

**Tab. 3: Links with foreign partners as potential incentives to IFRS usage**

	<b>Foreign customers</b>	<b>Foreign suppliers</b>	<b>Parent company</b>	<b>Another form of entry on the foreign market</b> <i>(e.g. capital market)</i>	<b>No contacts</b>	<b>Total</b>
	<i>Percent (No)</i>	<i>percent (No)</i>	<i>Percent (No)</i>	<i>Percent (No)</i>	<i>Percent (No)</i>	
Project GAČR Zlín + VSFS(2009-10)	10 (9)	28 (25)	20 (18)	--	42 (37)	89
Project IGA VŠFS (2010-11)	15 (18)	18 (22)	18 (22)	--	43 (51)	120
Project IGA VŠFS (2012-13)	30 (31)	37 (38)	28 (28)	--	43 (43)	102
Project IGA VŠFS + AAU (2014-15)	65 (168)	72 (185)	31 (80)	1 (3)	46 (119)	258

Source: own research

In the third part of the questionnaire, we examined how companies practically administer their accounting and how they solve the problems of transition to IFRS, i.e. whether the accounting is conducted within the company or by some external provider. See analysis in table 4.

**Tab. 4: Practice of accounting**

	Accounting firm	Own employees				Total
Project GAČR Zlín+VSFS (2009-10)	--	--	--	--	--	89
Project IGA VSFS (2010-11)	32%(38)	68%(82) Split as				120
		CAS 79%(65)	IFRS 16%(13)	US GAAP 4%(3)	Other 1%(1)	
Project IGA VSFS (2012-13)	45%(46)	55%(56) Split as				102
		CAS 66% (37)	IFRS 23% (13)	US GAAP 5% (3)	Other 5% (3)	
Project IGA VSFS+AAU (2014-15)	8%(20)	92%(238) Split as				258
		CAS 65%(155)	IFRS 27%(65)	US GAAP 4%(9)	Other 4%(9)	

Source: data acquired in enlisted projects

In all projects it has been revealed that more than half of the surveyed companies (from 55% to 92%) keep accounts by their own departments. A smaller share is represented by companies whose accounting is performed by an external provider - this proportion is changing from 8 to 32 per cent. As to professional accounting firms, accounting services using IFRS are offered by only 20 per cent. These findings confirm that the requirements and costs associated with the adoption of IFRS impose pressure on the industrial companies themselves, as the companies do not have the necessary support in the services offered by professional accounting firms. The reason for the use of IFRS was, in the vast majority of cases, the request of the parent company. Another reason was the requirement of the lending bank or vendor. As for the major issues in the transition to reporting under IFRS, the respondents enlisted the very diverse nature of reporting Czech Standards and, as compared to IFRS, cluttered data, a necessary or lack of training, and issues linked to conversion of the information system. The proportion of these effects and factors has not changed significantly.

Perceived problems, and to the contrary, the benefits of IFRS adoption, did not change significantly. The main issue was the subordination of accounting rules to tax reporting

purposes. The most often cited positive effects of the use of IFRS were easier access to loans and an easier increase in equity – see table 5.

**Tab. 4: Problems and effects of IFRS adoption**

<b>Problems</b>	<b>%</b>	<b>Evaluation</b>	<b>%</b>
CAS is subordinate to tax reporting	36	Easier reporting	1,6
Complicated terms under IAS/IFRS	25	Better comparison of accounting data	2,1
Different problem	16	Better quality of inter-company information	2,7
Big difference between CAS and IFRS	10	Better usage of data for business management	2,7
Insufficient instruction for first adoption	6	Higher credibility for business partners	2,9
Difficult translation	4	Better public perception	2,9
Nonexistence of some transactions used in IFRS	3	Getting loans easier	3,4
Insufficiently developed capital market	0	Easier increase of equity capital	3,4
Investors and users are satisfied with CAS	0	Easier issuance of bonds	3,6
		Better access to EU funding	3,4

Source: own research

On the other hand the most often cited reason of non-adoption of IFRS was as no benefits for the company (38%). The greatest benefit, was the most often stated better comparison of financial data and the easier reporting stated by companies-IFRS adopters, as – see table 5.

**Tab.5: Reaction on IFRS in condition of SMEs**

<b>Main reasons for not adopting IFRS</b>	<b>%</b>	<b>Are there any benefits from IFRS adoption for your company?</b>			
No benefits for company	38	Yes	17%	No	83 %
Don't know about benefits from IFRS usage	29	<b>What are the benefits of IFRS adoption?</b>		<b>%</b>	
Company is not issuer of securities	14	Better comparison of accounting data		69	
Other	11	Easier reporting		66	
Don't have a foreign business partner	9	Higher credibility for business partners		47	
		Better public perception		28	
		Better usage of data for business management		28	
		Better quality of inter-company information		22	
		Better access to EU funding		13	

Source: own research

## Conclusion

The research results provide realistic look at the perception of the IFRS, and the need for comparable and universally accepted financial statements in practice of the Czech companies. Positive effects of IFRS adoption are approved mainly by foreign businesses. This is apparent in relationships within large consolidated groups (Prochazka, 2017; Zarova & Mejzlik, 2009). If



a foreign parent company is obliged to use IFRS as an issuer of securities, then it also requires subsidiary companies to prepare consolidated financial statements according to IFRS.

The results of surveys performed four times since 2010 (Mullerova, Pasekova, & Kubickova, 2010; Jindrichovska & Kubickova, 2014 and 2016), show that IFRS is now used by about a quarter of the firms surveyed. Over the analysed period, the portion has gradually increased. The main reason and effects in the IFRS adoption are closely linked with the foreign elements of the economy – foreign owners of the businesses and a parent relationship to foreign companies. In the four stages of investigation there can be identified the relationship between the development of volume of foreign trade and the portion of companies using IFRS. The process of IFRS implementation and real use has thus reflected the reality and macroeconomic factors, as well as the changes in legal basis.

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