

The Quality of Accounting Information of Private Companies in the Czech Republic

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Abstract—The paper gives the evidence of quality of accounting information of Czech private companies. In general the private companies in the Czech Republic do not see the benefits of providing accounting information of high quality. Based on the research of financial statements of entrepreneurs and companies in Zlín region it was confirmed that the quality of accounting information differs among the private entities and that the major impact on the accounting information quality has the fact if the financial statements are audited as well as the size of the entity. Also the foreign shareholders and lenders have some impact on the accounting information quality.

Keywords—Accounting information quality, Financial Statements, Czech Republic.

I. INTRODUCTION

IN general the role of financial accounting is to provide information for both external as well as internal users of accounting information, represented by set of financial statements and notes to these financial statements. For public companies financial statements and notes serve mainly to their shareholders and the ability to prepare accounting information of high quality may affect their future development. For private companies the benefits of financial accounting are not so visible and mainly micro and small companies see financial accounting as something they need to prepare due to legislation needs but brings them no added value. The role of this article as well as further research at Tomas Bata University in Zlín is to provide an empirical study which will discuss the benefits of quality accounting information for private companies in the Czech Republic.

II. LITERATURE BACKGROUND

In the accounting theory the accounting should provide accounting information. The accounting data are used internally by organizations to plan, evaluate and diagnose the dynamics of operations and financial circumstances [3]. Similarly Romney & Steinbart [28, p29] specify that accounting information is meant to be "useful for decision making so that management can plan, execute, control, and evaluate activities, resources, and personnel".

Other authors define accounting information as "a representation of economic constructs that are embodied in a firm's commercial arrangements, transactions, and events that yield a firm's future cash flows" [25, p401]. Therefore the accounting information is not only management information,

but also information that is provided to other stakeholders.

The core users of accounting information are investors who use them together with other available information for their decision making. It was proved by many studies, that high quality of accounting information decreases the risk for capital investors, promotes investment activities, creates an efficient allocation of resources and therefore increases the chance of companies to raise funds at lower cost of capital [10], [14], [15], [19], [20], [23].

Lambert, Leuz and Verrecchia [24] build a model that is consistent with the CAPM and demonstrate that the quality of accounting information can influence the cost of capital, both directly and indirectly. The direct effect occurs because higher quality disclosures reduce the firm's assessed covariance with other firms' cash flows, which is non-diversifiable. The indirect effect occurs because higher quality disclosures affect a firm's real decisions, which likely changes the firm's ratio of the expected future cash flows to the covariance of these cash flows with the sum of all the cash flows in the market. They show that this effect can go in either direction, but also derive conditions under which an increase in information quality leads to an unambiguous decline in the cost of capital.

Besides management and investors, other users of financial statements are lenders, employees, suppliers, customers, governments and public [1].

Maines and Wahlen [25] defined Accounting Information Framework where accounting relevance and accounting reliability has been presented, see Fig. 1.

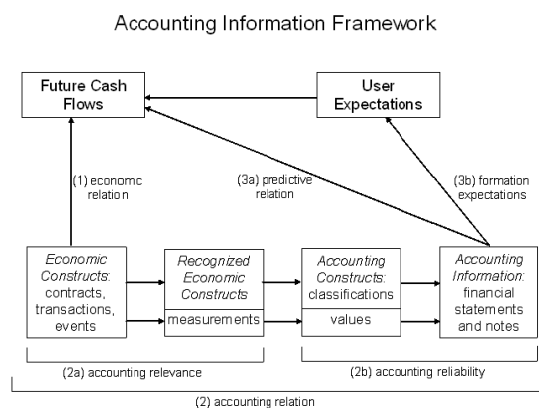


Fig. 1 Accounting Information Framework
Source: Maines and Wahlen, 2006 [25]

Accounting relevance or completeness as defined by other authors [8], [22], [27] relates to the recognition of relevant economic constructs, its classification, measurement and

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presentation. The accounting reliability or faithful presentation as defined by the International Accounting Standards Board requires preparers to provide financial information that are complete, neutral and free from error. Preparers' incentives may however lead to misrepresentation of accounting information to their own benefit [22].

The information content of financial statements of publicly traded firms can be studied directly by market share prices reactions on the released reports [2], [5]. Another approach to measure the quality of disclosed accounting information is to study conservatism in accounting [7], [16], [17].

All of the studies mentioned were focused on public companies. In case of private companies it is problematic to uncover the users' perception on usefulness of financial reports. The purposes of accounting information and incentives behind the preparation of financial statements by the company may be viewed as indirect measure of accounting information quality.

If company considers that the main purpose for preparing accounting information is tax authorities, the quality of financial statements can be questioned. This is characteristic for transitional economies that accounting data for the financial statements is prevailed by tax considerations [30]; these data are then not relevant for other stakeholders.

Bagaeva [4] has discussed the decision making, of international investors, domestic investors, and tax authorities and their effect on the quality of accounting information in Russia.

Other studies that have recently focused on private companies and quality of their accounting compared to public companies discuss the demand for high quality accounting information, opportunistic behavior and ownership dispersion [6], [11], [18], [21]. The authors stress the relevance of audited financial statements to the quality of accounting and argue that audited companies face lower financing cost [9], [21], [26]. The measure for the quality of financial reporting of private companies is not universally accepted [13]. For the assessment of the financial reporting quality the authors use the accruals persistence, cash flow predictability and measures of accruals quality [12], [21].

III. CZECH REPUBLIC SPECIFICS

To understand the role of accounting in the Czech Republic it is needed to understand the historical consequences. The tradition of bookkeeping began at the time of Austria-Hungary and after the first war there were some examples of highly-developed accounting and reporting practices in Czech well-known companies such as Bata. During the Communism however the only role of accounting was to provide information for central planning and the state become the only user of accounting information. After the transition process which started in 1989 the position of accounting has changed, companies traded on Prague Stock Exchange had to provide adequate information to their shareholders, international investors needed to obtain reliable and understandable accounting information, local creditors and business partners needed to understand financial statements of companies in

order to survive the overall liquidity crises. In 2004 the Czech Republic became a member state of EU and the accounting was harmonized. Currently the public companies shall present IFRS consolidated financial statements, individual financial statements shall be prepared under Czech Accounting rules (CZ GAAP). Companies that are part of a group preparing consolidated financial statements under IFRS are allowed to present the individual financial statements under IFRS but have to provide the reconciliation of IFRS profit or loss to profit or loss under CZ GAAP for the tax purposes This possibility is very used to time, companies prefer to keep accounting in CZ GAAP and to prepare IFRS reporting for their shareholders.

CZ GAAP is considered to provide less relevant and reliable information than IFRS. CZ GAAP is based on rules, while IFRS is based on principles. CZ GAAP also lacks the existence of conceptual framework and therefore there are some differences arising from the non-existence of definitions of basic elements of financial statements.

Main specific differences arise in the area of leasing (in CZ GAAP leased assets are not activated and payable not recorded), specific provisions that do not meet the criteria of provisions under IFRS, in the recognition criteria and valuation of inventory and assets, presentation, classification of income and expenses, impairment tests etc. [29].

Research regarding financial accounting quality in the Czech Republic was published by Hellström in 2006 and 2009 [19], [20], her research was covering periods 1994 – 2001 and she focused on public companies in Czech Republic and compared the value relevance of financial information of these companies to the value relevance of financial information of public companies from the Sweden. She has shown that the value relevance of accounting information is lower in the Czech Republic than in Sweden. She has also identified improving value relevance in the Czech Republic during the years of transition. Beside other she has focused on the accruals quality as a measure of accounting quality and on the voluntary disclosures.

Some of her valid points to be build up:

- i) High accounting quality and disclosure quality decrease investment risks and have in general a positive effect for the company. In situations when the accounting regulation is insufficient, companies can compensate these inefficiencies by voluntarily provided information. [20, p. 35].
- ii) Although the Czech companies improved their financial reporting throughout the transition period, they did not take advantage of full compliance with the regulation or voluntary disclosure in 2001. Improvements in this regard would in general have affected the value relevance of the accounting information positively [20, p. 35].
- iii) The results indicate that improvements in Czech accounting relate to better accounting information disclosure rather than improved recognition and measurement principles [20, p.217].
- iv) Czech earnings are more persistent and less smoothed and accounting information is more value relevant and timely.

At the same time accruals quality and predictability decrease. Czech accounting is also non-conservative [20, p 250].

- v) Disclosure quality is significant for value relevance of accounting information. The study finds that there is a difference between large companies and small companies as to the level of disclosure which might depend on the complexity of operations as well as on the costs for gathering and reporting accounting information. The type of auditors influences the level of disclosure provided by the companies. Employing Big Four auditing firms has a positive effect on the disclosure level. The third important factor which influences the amount of information disclosed is the type of owner. The results show that state owned companies have a poor disclosure quality and do not follow the accounting regulation as they should. This is a serious issue in a transition economy where the state ownership of companies still is substantial [20, p. 308].

Hellström results have important implications for the Czech companies and capital markets because the increase in value relevance and possibility of reliance on the information promotes investors interest in the economy, strengthens the country's credibility and has effects on the cost of capital.

IV. METHODOLOGY

In the Czech Republic the demand for quality accounting information is not as high as in developed countries. Most of the companies do not see any benefits from presenting quality financial statements and disclosure. Also the investors, creditors and other parties tend to use other sources of information for their decision making. This can be explained by the linkage to tax due to historical consequences as well by the fact that external users of accounting information doubts the relevance and reliability of accounting information presented. As the accounting quality of public companies has already been addressed by past studies, this study focuses on private companies and following hypothesis will be tested **“The quality of presented accounting information of private companies will differ due to various factors, the factors to be tested are:**

- i) size and legal form,
- ii) internationalization,
- iii) auditor,
- iv) proportion of external financing”.

To test the hypothesis it has to be defined how to measure the quality of accounting in Czech private companies. In this first stage it was decided not to use models presented in recent studies but to score the financial statements of companies based on the attributes they include. The higher score the better quality of financial information provided.

Attributes to be evaluated.

Corrections arising from errors presented as part of extraordinary items - it is assumed that the accounting information are free from errors therefore no such corrections are needed (EXTR)

Deferred tax – in the company where the accounting is closely linked to tax no time differences arise as there is no

differences in the net book values of assets, the accounting provisions equals tax provisions etc. Also if there are any time differences and the company doesn't book deferred tax liability the information provided are not relevant and reliable (DT)

Specific provisions that do not meet the criteria of provisions - typically provision for future repairs, if there is no future liability the provision shall not be booked even if it is allowed to be used as tax allowance (SProv)

Usage of accruals – if the company doesn't use the accruals it can be assumed that the costs are not booked to relevant accounting period (ACCR)

Presentation of Cash flow statement – the presentation of Cash flow statement is not mandatory for all companies in the Czech Republic however if cash flow is presented it obviously gives higher value to the users of financial statements (CF)

The quality score of the accounting data can be described as

$$Qscore = \alpha_1 EXTR + \alpha_2 DT + \alpha_3 SProv + \alpha_4 ACCR + \alpha_5 CF$$

where:

- i) α_1 equals 1 for companies with no extraordinary items and 0 for companies having extraordinary items,
- ii) α_2 equals 1 for companies accounting for DT and 0 for companies with no DT booked,
- iii) α_3 equals 1 for companies not booking specific provisions, 0 for companies accounting for specific provisions,
- iv) α_4 equals 1 for companies booking for accruals and 0 for companies with no accruals in their financial statements,
- v) α_5 equals 1 for companies disclosing cash flow statement and 0 for companies not disclosing cash flow statement,
- vi) the importance of all attributes evaluated were set equal ($EXTR=DT=SProv=ACCR=CF=1$).

V. SAMPLE AND DATA

To test the hypothesis companies and sole entrepreneurs from Zlín region have been selected (together 91 entrepreneurs and 7512 companies), data were available up to 7 years back. Total sample of financial statements was 35057 individual financial statements for companies and 347 individual financial statements for entrepreneurs. The relatively low number of entrepreneurs in the sample is reasonable due to the fact that in the Czech Republic entrepreneurs can choose if they will keep accounting or if they calculate their tax base from revenues using defined % to calculate costs. To use % for cost calculation is quite favorable for the entrepreneurs therefore is often used by them. On the other hand some of the entrepreneurs prefer to set up limited liability company for doing business (more than 24 000 financial statements of micro companies in the sample). The entities in liquidation were excluded from the sample.

For each individual financial statement the 5 attributes were evaluated and the total score of quality was calculated using the equation in Methodology (see IV.). The total quality score amounts from 0 to 5, where 5 represent the highest financial

statements quality. The average quality score for the total sample was 2,582 for financial statements of entrepreneurs and 2,591 for financial statements of companies which is in line with the expectation and approves that the quality of financial information presented by Czech companies is not high in general. None of the entrepreneurs reached the highest quality score of 5, for the companies there were 191 financial statements with highest score, on the other hand none of the analyzed financial statements had the lowest score of 0.

VI. HYPOTHESIS EVALUATION

To evaluate the hypothesis relations between the quality score and the factors have been studied using simple statistics (mainly min, max, mean and median values and standard deviation).

For testing the effects of size and legal form aspects, the sample was sorted into 3 sub-groups for the size (<10 employees representing micro entities, < 250 employees representing small and medium sized companies and > 250 employees representing big companies). For testing the legal form the categories limited liability company and joint stock company were tested, other types of entities were not tested due to their low impact. For the size and legal form following conclusions have been observed:

- i) the quality of financial information is much more linked to the size of the entity than to the legal form, with the highest quality for entities over 250 employees, where mean quality score equals to 3,758 for companies and 4 for entrepreneurs,
- ii) the mean quality score of joint stock companies equals to 3,069,
- iii) the mean quality of limited liability companies, entrepreneurs, micro entities under 10 employees and entrepreneurs under 250 employees is in interval from 2,481 to 2,590 which is not significantly different from the total sample,
- iv) the mean quality of companies up to 250 employees in the amount of 2,853 in slightly higher.

For the internationalization the type of ownership has been used for sorting the sample of companies. Two subgroups (pure Czech companies and companies with foreign shareholders) have been analyzed. The companies with foreign shareholders have higher quality score (mean quality equals to 2,72) than pure Czech companies (mean 2,579). The influence of foreign shareholders was expected to be more significant. From further analysis there are obvious big differences in quality score within the foreign shareholders sub group. It can be assumed that the effect on the quality corresponds to the share of foreign shareholders as well as to the significance of the Czech entity for the foreign owners. This has to be further investigated in greater detail.

Regarding the aspect of the fact that the financial statements are audited the financial statements with unmodified or clear audit opinion has been selected. Here we can see that the linkage between the audited financial statements and the quality of the financial statements is clear, mainly for companies where the mean quality index was 4,007. For the

entrepreneurs the effect was not so visible, the mean quality index is only 2,857. This can be interpreted by the different quality of auditors (usually the entrepreneurs are audited by local auditors but in the company's sample the big 4 auditors are present).

For analysis of proportion of external financing the entities with long term bank debts were tested. Here we can see slightly higher effect on the financial statements quality by entrepreneurs than by companies (mean quality score is 2,818 for entrepreneurs and 2,798 for companies).

VII. CONCLUSION

To sum up the quality of accounting information presented by Czech private companies is not very high and corresponds with the fact that the financial statements are not the core source of information for decision making. The hypothesis that the quality of the presented financial data will differ has been confirmed. The main factors influencing the accounting information quality is the size of the company and the fact that the financial statements are audited. It was also confirmed that the lenders and foreign shareholders have some impact on the financial statements quality. The Czech private companies should take more care about the presentation of financial statements of high quality and to profit from it in way it was described by academics (e.g. lower cost of capital, better information for decision making etc.). For the users accounting information the fact that the financial statements are audited gives higher value to them and assures the higher quality than if the financial statements have not been audited. It should be in the interest of the users of financial statements, mainly shareholders and lenders to increase the demand for the high quality accounting information.

The interpretation of these findings has also some limitations which have to be taken into account. Firstly the sample covered only Zlín region not whole Czech Republic. Secondly the data were used from the external source (the SW Albertina) and therefore full reliability cannot be assured.

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