Auditor’s Insight on Prudence Principle Application in Czech SMEs

MARIE PASEKOVÁ
Department of Finance and Accounting
Tomas Bata University in Zlín
nám. T.G. Masaryka 5555, 760 01 Zlín
CZECH REPUBLIC
pasekova@fame.utb.cz

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

LIBUŠE MÜLLEROVÁ
Department of Financial Accounting and Auditing
University of Economics Prague
W. Churchill Sq. 4, 130 67 Prague 3
CZECH REPUBLIC
muller@vse.cz

Abstract: - The paper deals with the creating of provisions, impairment and depreciation of fixed assets in SMEs from the auditor’s perspective. Prudence principle belongs to traditionally generally accepted accounting principles and is closely linked with another accounting principle - going concern in the foreseeable future. Both of these accounting principles, based on which accounting systems are built, have one common denominator; it is measurement as one of the basic methodological elements of accounting. The fundamental problem in the use of the above instruments of prudence principle in SMEs is a strong dependency of accounting of the companies on tax incidences.

Key-Words: - Prudence principle, small and medium sized enterprises (SMEs), measurement, impairment, provisions, depreciation auditors’ insight, Czech Republic.

1 Introduction
Prudence principle belongs to traditional generally accepted accounting principles and is closely linked with another accounting principle - going concern in the foreseeable future. Both of these accounting principles, based on which accounting systems are built, have one common denominator; it is measurement as one of the basic methodological elements of accounting.

Measurement, or more precisely value expression, can be called a common accounting language, which records the ongoing economic events of an accounting entity. Accounting theory puts certain requirements on the measurement, especially

- fair value measurement so the monetary expression corresponds to the actual resources spent;
- uniformity measurement that should ensure the comparability of measurement of the same resources both within one entity and among enterprises and in time;
- reliability measurement is a requirement that the value of a certain item can be reliably determined;
- stability measurement which requires that the measurement has not been influenced by insignificant temporal fluctuations.

During the practical enforcement of these requirements various problems may occur; the stated principles, in particular, may get into disagreement with each other. Under certain conditions, stability measurement may be subject to...
contrary to the fair value measurement; the uniformity may not respect the individual conditions and may become unreliable. Therefore, we cannot say that there is only one correct method of measurement, which ensures compliance with all such requirements.

The objective of measurement is essentially to provide users of accounting with two basic groups of information:

- information on the financial position of an accounting entity that demonstrates the ability to optimally allocate assets and resources of financing, which the entity has. At the same time, this gives information about its financial position and also the ability to continue its work in the future;
- information on profit/loss achieved during the reported financial year, which characterizes how effectively the entity used its resources and sources.

Both these groups of information are linked together and should be considered as interrelated. Under certain circumstances, positive financial results can be temporarily achieved, however, at the expense of the financial structure or financial equilibrium, possibly at the expense of the future development of accounting entity. On the contrary, a short-term adverse loss may not necessarily represent a threat to its future.

The question is to what extent an auditor should take into account these facts in auditing the financial statements. The auditor’s opinion expresses as to whether the financial statements give a true and fair view of financial position of an entity and profit/loss for the monitored period. The auditor therefore does not pass judgement on the entity’s good or poor financial performance. If the financial statements fairly present poor financial performance, the auditor may issue a clean opinion. Not every user of the auditor’s report, however, perceives the auditor’s opinion this way. So if the performance of the accounting entity is in such a degree and so poor in the long term that the entity is at risk in the foreseeable future, the auditor should - in accordance with auditing standards – inform the user of the auditor’s report with a note under the opinion (so-called emphasis of matter).

A conceptual framework for international financial reporting standards provides prudence as one of the qualitative characteristics of financial statements. It draws attention to the fact that financial statements processors must address the uncertainty, recognize it, and express its nature and scope. Prudence means a degree of caution in making estimates under uncertain conditions. Eventually, the assets or revenues should not be overestimated and liabilities or expenses underestimated. On the other hand, exaggerated prudence could lead to the creation of hidden or excessive provisions, causing the financial statements not being impartial and reliable.

International financial reporting standards work with a variety of measurement bases (historical cost, current cost, realisable value, present value and fair value) which are applied in varying degrees and in different combinations. The Czech accounting legislation enables an application of the following measurement bases (historical cost, production cost, replacement cost, nominal value and fair value).

The prudence issue is included in IAS 36 - Impairment of Assets.

If the recoverable amount of an asset is less than its carrying amount, the company must reduce the carrying amount to its recoverable amount. This reduction is called an impairment loss and is recognised immediately in the income statement. The exception is when the asset is carried at revalued amount and the impairment loss reduces the revaluation reserve in accordance with relevant standards (e.g. IAS 16 - Property, Plant and Equipment or IAS 38 - Intangible Assets). After the recognition of an impairment loss, it is necessary to adjust depreciations in future periods to allocate a new carrying amount less its residual value over the remaining useful life of asset.

A decrease or a reversal of an impairment loss for an asset is immediately recognised in the income statement, except where the asset is carried at revalued amount under another standard (e.g. IAS 16). After reporting reversal of an impairment loss, depreciation of assets for future periods shall be adjusted to allocate the revised carrying amount of the asset less its residual value over the remaining useful life of asset.

The issue of determination of impairment loss and its reversal is a problem and can be viewed as one of possible tools of creative accounting from companies. Companies by means of reporting impairment losses and reversals “pour” profits from one accounting period to another and thus align, for example, fluctuations in financial performance, or achieve planned financial gains in a given period. It is also one of the reasons why, e.g., U.S. GAAP requires accounting for impairment losses but prohibit their reversal.
2 A Brief Literature Review on the Linkage of Taxation and Local Accounting Systems

The separation of tax statements and financial statements is common practice in many countries. European countries have discussed abolishing book-tax conformity. E.g. Spain has relaxed the strong link between tax accounting and book accounting; France and Austria are discussing clearer separations of their accounting systems in the future [2, 14, 18].

A large strand of literature has examined the connections between tax and financial accounting. Many authors identify increasing divergence in reported financial and taxable income, e.g. [1]. [4, 7, 13] discuss costs and benefits of a possible book-tax alignment. All of them emphasize disadvantages of such a development. [9] identify a strong tax influence on financial accounting regulations in Germany. Compared to other countries, [3] describe a (implicit) strong emphasis on the conservatism principle in German financial accounting regulations, which is partly due to its closeness to tax accounting. [8] discuss investment incentives caused by a one-book or a two-book accounting system. [11, 12] provide an overview of the literature dealing with the developments in national financial reporting systems.

[16] provide a framework for measuring tax rate and tax-base effects and discuss the optimal complexity of taxable income. [15] empirically measures the complexity of the tax systems of US states. [6] find that nonuniformity among US states’ tax systems increases corporations’ compliance cost burdens; [10] identifies ongoing nonconformity and concludes that compliance costs will remain “needlessly high”. Transferring these findings to the current Czech situation, one might argue that reporting three parallel income statements as it is required induces high compliance costs.

Czech system is obviously considered as a very close to German one. We can find a number of qualitative papers dealing with possible new determinations of taxable income for German companies. However, analyses quantifying the effects of alternative tax bases on the tax burden of companies are rare. Quantitative evidence is provided by [2, 5]. [5] analyzes differences between US GAAP and the current German tax base and finds that German companies would save taxes if German taxable income was connected to US GAAP. [17] finds that the tax burden of companies would decline if uniform accounting based on IFRS was implemented. In Austria, [2] uses a business model simulation to analyze various tax bases, including the IFRS and US GAAP. But according to the most recent publications, there will be no uniform accounting based on IFRS or US GAAP either in Austria or in Germany.

3 Prudence Principle Application in SMEs

SMEs often work with historical cost, which indisputable advantage is its conclusiveness. On the other hand, its disadvantage is the obsolescence and thus breach of the condition of fair value measurement. However, despite this fact, it is clear that in combination with other measurement instruments, historical costs are the most suitable base of measurement) from the perspective of prudence Principle. The fundamental problem in the use of the above instruments of prudence Principle in small and medium-sized enterprises (reserve provisions, allowances, and depreciation expenses) is a strong dependency of accounting of the firms on tax incidences.

The issue of provisions, allowances and write-offs for SMEs was studied by the authors by a simple questionnaire. About 500 companies were approached during this research. Only 202 companies filled in questionnaire. For purposes of this paper, only following questions were processed:

- Does the company make provision (none, legal, other)?
- Does the company use impairment (none, legal, other)?
- What type of depreciations does the company account (tax and accounting depreciation)?

3.1 Provisions Issues

SMEs make provision only if it has tax advantages for them. According to the Act on Provisions there are mentioned those affecting the tax base. For business entities it mainly involves provisions for repairs of long-term assets. The Act determines detailed rules for how long and to what amount is possible to form provisions for repairs of long-term assets and how to use them in case that the repair was made, or its implementation cancelled. Creation of provisions for repairs was misused in the long term to reduce the tax base, especially in the past when there was a prospect of reducing the tax rate in future periods. For example, if an accounting entity started a provision during the period when the income tax rate was 24% knowing that the repair will be implemented in four years and at that time
the tax rate is planned to be reduced to 19%, the creation of provision at a higher rate and vice versa it cancellation at a lower rate meant tax savings.

Given that some accounting entities formed provisions in good faith to actually carry out the repair, but when it should happen, they were unable to fund them. For this reason, the Act on Provisions added a condition for the creation of provisions – to transfer the same amount of money to a special bank account. Thanks to this measure the creation of provisions ceased to be interesting for the entities and most small and medium-sized enterprises stopped using it.

This fact is illustrated by the result of research. Most companies (59%) make legal provisions; a large portion of enterprises (30%) does not calculate any provision at all. Only 8% of companies present other provisions and a very small portion of 3% of businesses report both legal and other provisions.

3.2 Impairment Issues
Just as for provisions, the impairment might have some tax implications. According to the Act on Provisions, it is possible to create tax deductible impairment on bad debts. The creation and use of such impairment is regulated by the Act in the following four modes:

- impairment for receivables for insolvent debtors;
- impairment for outstanding receivables in the event that it has been more than 6 months since the end of the agreed period for payment, up to 20% of book value of receivables. Higher impairment for the receivables can only be created by the income tax payers, who have submitted a proposal to initiate proceedings against the debtor pursuant to the provisions on arbitration or court;
- impairment for receivables arising from guarantee for the customs debt (i.e. the provision of customs debt) under the customs law;
- impairment for receivables can be formed up to 100% of the outstanding balance value without accessories under the conditions that, on the date of making allowances for the taxpayer the total value of receivables without accessories incurred to the same debtor to which this approach is applied, does not exceed the amount of CZK 30 000.

Thus, if SMEs make impairment, then it is only for bad debts with tax implications. Impairments are calculated for the other items of assets only in exceptional circumstances (e.g. for slow-moving or unsellable inventory) and only under pressure from auditors, if they have a statutory audit.

The questionnaire survey shows that 30% of enterprises do not make impairment for bad debts. A portion of 21% SMEs make only the tax impairment for bad debts and 22% of enterprises make just non-tax impairments. The remaining 27% of companies report both types of impairment.

The vast majority of enterprises, more than 95%, do not calculate any impairment to inventories.

3.3 Depreciation Issues
Income Tax Act regulates tax depreciation. Since the Accounting Act requires entities to prepare a depreciation schedule, it is not an exception when an accounting entity charges depreciation in the amount of tax depreciation. This has resulted in a significant distortion of assets, because the tax deprecations do not respect the expected useful life. Accounting entities in the acquisition of assets assign the assets to one of 6 groups of tax depreciation, to which the tax life is assigned.

Most SMEs report tax depreciation once a year. It has the advantage that it is not necessary to quantify the difference between accounting and tax depreciation in the tax return and adjust the tax base. Also on disposal of fixed assets not fully depreciated, there is no need to find out the difference between accounting cost and tax residual cost. On the other hand, this procedure is unacceptable from the auditor’s point of view.

The questionnaire survey shows that 78% of companies recorded tax depreciation. Surprisingly, almost one fifth of companies accounted for an accounting depreciation. Only 3% of companies recorded tax as well as accounting depreciation.

4 Auditor’s Insight
Auditor monitors the measurement of various items of assets and liabilities reported in the balance sheet. In case of long-term assets, the auditor considers whether the method of depreciation complies with the expected useful life. If the accounting entity reports tax depreciation, it must assess to what extent this kind of depreciation can be tolerated in terms of fair presentation. An important role is played by the issue of significance unfolding from the volume and value of long-term assets. For this group of assets, it is not usually common to make allowances. However, there may be situations where there is, e.g., a temporary impairment of these assets (e.g. due to fire, flood, etc.) and this temporary impairment needs to be expressed by an allowance.
The most problematic situation from the auditor’s point of view regards inventory. If an accounting entity does not evaluate the accuracy of inventory measurement, the inventory may be overvalued.

The receivables are one of the most complex areas; it is necessary to continuously monitor the maturity and eventual recovery. If an entity does not care for receivables, it can get into secondary insolvency. As mentioned above, accounting entities usually make tax allowances, an auditor should, however, insist on making allowances, regardless of whether or not they are tax efficient. The auditor has to pay the same attention to liabilities, particularly in terms of whether the entity is able to repay liabilities, whether it is not on default with payment, or follows a repayment plan.

A separate chapter are accounting estimates. It does not have to involve estimated unbilld items only. It is necessary for the auditor to monitor the possibility of legal disputes and to recommend an entity to form provisions not only with tax incidences, but for all the risks that may threaten the entity.

The auditor should consider it all and issue a relevant opinion based on all findings. If the prudence Principle is not sufficiently respected on the part of the accounting entity, the auditor must express it in the opinion. This is usually a qualified opinion if the assets are overvalued or liabilities undervalued. The amount of the overestimation or underestimation should be quantified by the auditor specifying the impact on profit/loss. A frequent argument of accounting entities for not creating provisions or allowances is that the entity is at a loss anyway. To assess the fair view of financial position, the amount of the loss is important as well.

There we have already come to one of the most important accounting principles that the auditor should consider when auditing each financial statement, and which are closely linked with the prudence Principle - the going concern principle in the foreseeable future.

International Standard on Auditing ISA 570 pays to the principle of going concern considerable attention. It requires the auditor to assess whether there is a significant uncertainty regarding the entity’s ability to going concern, which would have to be disclosed in the financial statements. The Standard provides examples of events and circumstances that represent business risks that can challenge the assumption of going concern. They include e.g.:
- the liabilities of an accounting entity are greater than the assets;
- negative operating cash flows;
- adverse key financial ratios (solvency, liquidity);
- substantial losses from operations;
- delayed or suspended payments of dividends;
- inability to pay overdue liabilities;
- failure to comply with the terms of credit agreements;
- loss of key customers or lack of essential supplies;
- difficulties with employees;
- ongoing litigations.

One of the basic requirements for the auditor’s approach to the financial statements is professional scepticism. The auditor must assess whether the financial statements adequately describe the fact that the entity’s ability to continue its activity is at risk. Only in this case, s/he may issue an unqualified opinion, with a possible additional paragraph, which shall draw the user of auditor’s report to the significant uncertainty in the entity’s ability to persist in the foreseeable future.

5 Conclusion
The objectives and functions of an audit of financial statements must be understood in broader image. Auditors’ activities are affected not only by the specific economic environment in which they provide their services, but also a historical and cultural tradition that has influenced the accounting systems and the related financial reporting. Differences between Anglo-Saxon and continental approach to accounting and financial statements also lead to a different approach to the auditor’s work with financial statements. While in the Anglo-Saxon area an auditor verifies whether the financial statements prepared on the basis of accounting comply with generally accepted accounting principles, an auditor in the continental area considers whether financial statements are in accordance with applicable national legislation. Because of the globalization trend, the harmonization of legal and accounting systems, these differences between the two extreme approaches are starting to disappear.

It should be pointed out that this applies particularly to large accounting entities, where the distinction between the accounting framework that respects national legislation and accounting based on international accounting standards is starting to disappear. While in SMEs there is still a strong link to the national tax system, the perception of the prudence principle is strongly weakened and
ultimately affects the ability of the financial statements to give a fair and true view of financial position and the profit/loss of an entity.

Acknowledgment
This paper is one of the research outputs of projects GA402/09/0225 and P403/11/0002 registered at Czech Science Foundation (GAČR).

References: