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ROSC
Report on the Observance of Standards
and Codes on Accounting and Auditing

Update

Czech Republic

June 2013



ECCAT

EUROPE AND CENTRAL ASIA

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Main Abbreviations and Acronyms

| | |
|----------------|--|
| A&A | Accounting & Auditing |
| CFRR | World Bank Centre for Financial Reporting Reform |
| CNB | Czech National Bank |
| EC | European Commission |
| FDI | Foreign Direct Investment |
| FRTAP | Financial Reporting Technical Assistance Program |
| GDP | Gross Domestic Product |
| GoCR | Government of Czech Republic |
| IAASB | International Assurance and Auditing Standards Board |
| IAS Regulation | Regulation 1606/2002 on International Accounting Standards |
| IASB | International Accounting Standards Board |
| IFAC | International Federation of Accountants |
| IFRS | International Financial Reporting Standards |
| ISA | International Standards on Auditing |
| KACR | Chamber of Auditors of the Czech Republic |
| Czech GAAP | Accounting Law, Decrees and Standards |
| MoF | Ministry of Finance |
| NAC | National Accounting Council |
| PSE | Prague Stock Exchange |
| APOC | Audit Public Oversight Council |
| ROSC | Report on the Observance of Standards and Codes |
| SAD | EU Statutory Audit Directive (2006/43) |
| SOE | State-Owned Enterprises |
| SME | Small and Medium Enterprises |
| SMOs | IFAC Statements of Membership Obligations |
| SMP | Small and Medium Practices |
| UOA | Czech Union of Accountants |
| VAT | Value Added Tax |

Currency: Czech Koruna

1 USD = 19.88 CZK as of June 30, 2013

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Executive Summary

The second Report on the Observance of Standards and Codes Accounting and Auditing (ROSC A&A) for the Czech Republic provides an updated assessment of the financial reporting requirements and practices in the country's enterprise and financial sectors from the 2003 ROSC A&A. It was conducted at the request of the Czech Government under a Reimbursable Advisory Services arrangement with the World Bank, the Financial Reporting Technical Assistance Program managed by the Centre for Financial Reporting Reform, and funded by the Swiss Enlargement Contribution.

This report uses International Financial Reporting Standards (IFRS), International Standards on Auditing (ISA) and the relevant portions of European Union (EU) law (also known as the *acquis communautaire*) as benchmarks.

The Czech Republic transposed the *acquis* as part of its accession process. Since 2004, it has further adopted new EU directives in its legal framework and applied EU regulations. The *acquis* is the main driver of any economic area that is regulated by the EU, including corporate financial reporting. The corporate financial reporting elements of the *acquis* mostly consist of the directives on accounting and auditing that comprise the Fourth, the Seventh and the Eighth Company Law Directives. The IAS Regulation on the application of International Financial Reporting Standards (IFRS) became applicable for financial statements of companies if their securities are admitted to trading on a regulated market of any member state in 2005.

Country Context

The Czech Republic became an independent state in January 1993 after Czechoslovakia split into its two constituent parts. The country has borders with Poland to the north, Germany to the west, Austria to the south, and Slovakia to the east. It has been a member state of the European Union since 2004.

The Czech Republic has a stable population of about 10.5 million. Its gross domestic product (GDP) per capita was US\$20,407 in 2011, twice its level in 2003. Manufacturing is still a significant economic activity, accounting for 37.6% of GDP, with an emphasis on the production of automobiles, machine tools, and engineering products.

The Czech Republic ranks 65th worldwide with respect to the ease of doing business (Doing Business 2013 Index). The country has substantially improved the effectiveness of its insolvency procedures (ranked 34th); and obtaining credit is comparatively easier than in many other countries of the world (ranked 53rd). At the same time, it lags with respect to barriers to entry into business (ranked 140th).

The accounting directives set the maximum thresholds that determine the accounting and auditing obligations of small, medium, and large limited liability entities. Member states often define lower thresholds when they adopt these directives, and take advantage of

currently allowed options. The Czech Republic applies the EU thresholds to exempt small groups of consolidation and to exempt small companies of audits; it permits companies that are exempted from audits to publish abridged financial statements. In 2011, the EC issued a directive simplifying the accounting obligations of micro-entities, which is now a member state option; and it proposes a new directive that harmonizes SME thresholds for all EU member states.

In the Czech Republic, all companies are required to prepare financial statements regardless of their size or legal form. There are around 384,000 companies in the Czech Republic, of which 25,000 are joint stock companies and 336,000 are limited liability companies. Only around 7,000 joint-stock companies (28 % of the total) and about 11,000 limited liability companies (3% per cent of the total) are subject to statutory audit.

Accounting and auditing statutory framework

The Czech Republic's legal framework for accounting and auditing is fully aligned with the acquis

The Czech Republic has fully aligned its legal framework with the EU *acquis communautaire* as it relates to accounting and auditing and implemented most of the recommendations of the previous ROSC A&A. In 2003, the earlier ROSC A&A recommended further identification of discrepancies with the EU directives. The country has now implemented the IAS Regulation requiring EU-*endorsed* IFRS for the preparation of consolidated financial statements of companies whose securities are issued on an EU regulated market. In 2009, the Act on Auditing established an Audit Public Oversight Council (APOC), responsible for overseeing the operations of the Chamber of Auditors of the Czech Republic (KACR).

Subsidiaries of listed companies are allowed to use IFRS

The Czech Republic requires listed companies that prepare financial statements under the IAS Regulation and allows their subsidiaries to prepare their legal-entity financial statements under *endorsed* IFRS. It also allows non-listed companies to prepare their consolidated financial statements under *endorsed* IFRS, and the parent company to use *endorsed* IFRS for its legal entity financial statements. *Endorsed* IFRS is not mandatory for banks and insurance companies, except those that issue securities on regulated segments of the Prague Stock Exchange.

Accounting and auditing standards

The MoF sets accounting standards that are a useful complement to the accounting law

The Ministry of Finance sets Czech GAAP. Czech GAAP are specified in the Act on Accounting and in the decrees that implement the requirements of the EU Fourth and Seventh Company Law Directives. The Ministry of Finance has supplemented the Act on Accounting and the related decrees for the enterprise, banking and insurance sectors, with accounting standards that provide for bookkeeping arrangements and disclosure requirements. It has also set up an Advisory Council for the Development of Accounting and Auditing to assist in identifying further reforms.

NAC provides guidance on the application of accounting standards

The National Accounting Council was created by the University of Economics, Prague and the tax, accounting, and auditing professional bodies to assist the profession in implementing accounting standards. It provides interpretations on accounting, which though not legally binding, aim to guide professionals in applying the relevant laws and accounting standards.

Czech GAAP and the income tax base are closely linked but with some exceptions

The income tax base and profits for reporting purposes are closely related, involving few adjustments. Typical adjustments are mandated for calculating the income tax base. The close link between financial reporting and tax accounting is a key element for keeping the administrative burden related to the tax declaration bearable. There are, however, some revenue recognition and sectoral exceptions that make the tax system more complex. Companies that prepare legal-entity financial statements in conformity with EU-endorsed IFRS still need to use Czech GAAP for calculating their income tax base.

International Standards on Auditing are used by statutory auditors since 2006

In 2006, Czech Auditing Standards were replaced by International Standards on Auditing (ISA). KACR is responsible *inter alia* for issuing auditing standards and for translating and publishing the ISAs. This is a major improvement from 2003, as Czech Auditing Standards were then of lower quality than the ISAs. KACR has introduced a large scale program to train auditors in the new, clarified ISAs. That effort is supported by the Financial Reporting Technical Assistance Program.

Accounting and Auditing Education

KACR has established a professional education and certification program that complies with EU and international requirements

KACR has established a certification program that complies with both the Statutory Audit Directive and the standards issued by the International Accounting Education Standards Board, including continuing professional development requirements. The Union of Accountants has assisted the development of the Chamber of Certified Accountants, a body operating a certification program inspired by the Association of Chartered Certified Accountants, whose qualifications are widely used in Central and Eastern Europe.

Filing and publication requirements

Filing requirements are not complied with and are also not enforced

Filing requirements are not enforced at the Commercial Register, in part because monitoring systems have serious design issues and fines are discretionary and seldom applied. In some other European countries, penalties for not filing financial statements on time are triggered quickly and those fines escalate when filing obligations continue not to be met. Although it is not comparable to the Commercial Register, the Czech National Bank (CNB) maintains a single registry for financial statements of regulated companies that includes all their financial statements and

interim financial statements, as required under the Transparency Directive and enforces compliance.

Quality of financial statements

Listed companies IFRS-based financial statements are generally of high quality...

The review of a sample of IFRS-based financial statements by the ROSC team indicates that companies whose securities are listed on a regulated market implemented *endorsed* IFRS to a high quality standard. The team noted that a substantive effort was made by most of the companies to avoid boiler plate language and to link disclosures to their transactions.

Financial statements of non-listed companies filed at the Commercial Register are of uneven quality

In contrast, several financial statements prepared under Czech GAAP by non-listed companies and filed at the Commercial Register were of uneven quality. Several sets of financial statements were incomplete especially in the area of disclosures. In several instances, audit reports were not filed. The Czech SME sector seems to be very sensitive to disclosing financial information that might adversely affect negotiations

with clients or provide strategic information to competitors.

Auditing is the sole mechanism that reviews the quality of implementation of IFRS

In terms of enforcement of financial reporting obligations, the CNB is not directly responsible for monitoring and enforcing the application of accounting standards and relies on statutory audits to review the quality of financial statements. The CNB acts as an integrated supervisor for banks and insurance companies, as well as companies that issue securities on a regulated market, brokers, dealers and fund managers. Since

2010, it has started performing off-site reviews of IFRS financial statements for 6-7 listed companies (10 per cent of all listed companies) on a yearly basis. The CNB also reviews auditors' management letters for these companies, and follows them up with both the companies and their auditors. The review of management letters is considered by the CNB to provide a good indicator of the quality of data and also of the risk approach of audits. In practice, the tax authority may review financial statements and supporting documentation, but it is not responsible for enforcing Czech GAAP.

Audit oversight and quality assurance

APOC oversees all activities of the Chamber of Auditors, including quality assurance

A public oversight authority was established in 2009 to monitor and supervise statutory auditors. It oversees the quality assurance and the other operations of the KACR. Its emphasis so far has been on close collaboration to build on the experience of the KACR. The Czech Republic has yet to fully implement the EC recommendation on quality assurance, but members of the Audit Public Oversight Council (APOC)

actively participate in some audit firm reviews. The Council is predominantly funded by the state budget.

KACR made significant efforts in order to enhance its quality assurance system but faces a challenge to complete its first cycle of reviews on time

KACR made significant efforts in order to enhance its quality assurance system by expanding its staff and by adopting updated methodologies for implementation of the quality aspects of the Act on Auditing. The quality assurance system is supervised by the Supervisory Commission of KACR and APOC. The first challenge of the quality assurance team is to perform a complete cycle of reviews according to the new law, i.e. on a 3 year cycle for firms performing the audits of public interest entities, and a 6 year cycle for auditors and/or firms that audit non-public interest entities. The schedule of the quality assurance team is made more challenging by the need to follow up on those audit firms whose quality was assessed to be substandard.

Small audit firms and sole practitioners face more difficulties in applying ISA

The first findings from these reviews indicate that the bigger firms carry out higher quality audits. Sole practitioners and small firms face greater challenges, as they often lack the resources to keep up with technical developments in accounting and auditing. Instances of non-compliance have been found in all areas of audits: incomplete terms of engagement, inadequate risk assessment and planning, lack of documentation, and evidence that is not sufficient to support an audit opinion.

The main areas for the government and other stakeholders' consideration are:

Accounting and Auditing Framework: Raising the accounting and reporting thresholds for small companies and alleviating the reporting obligations for micro-entities;

Filing of financial statements: Enhancing the filing ratios of financial statements at the Commercial Register by imposing a well-defined system of fines and set-up an operational enforcement system;

Education and Training: Systematically including key findings stemming from the quality assurance reviews in the auditors' Continuing Professional Development Program;

Public Oversight and Quality Assurance: Strengthening the capacity of APOC to supervise the audit quality assurance system and making its public reporting more effective; and

CNB's Monitoring and Enforcement: Broadening the role of the CNB on enforcement of IFRS for regulated entities and the monitoring of the quality of financial statements.

I. Introduction

- 1 Reports on the Observance of Standards and Codes (ROSC) Accounting and Auditing (A&A) assess accounting and auditing practices in participating countries. They form part of a joint initiative that is implemented by the World Bank and the International Monetary Fund to review the quality of implementation of twelve internationally recognized core standards (the ROSC Program). These standards and their related codes are relevant to economic stability and private and financial sector development. The program was developed at the end of the 1990s, in the wake of financial crises that affected many countries in several regions of the world. Since its inception in early 2000, the ROSC A&A program has concluded evaluations of the A&A environment in more than one hundred countries around the world. ROSC A&A reports have been produced for all countries of the Europe and Central Asia Region, except Russia.
- 2 **This updated ROSC A&A updates the findings of the previous report on the Czech Republic conducted in 2003.** It was drawn up at the request of the Czech government as part of the Financial Reporting Technical Assistance Program (FRTAP), a fee-based service arrangement with the Czech Government, managed by the World Bank Centre for Financial Reporting Reform (CFRR). The FRTAP is financed by Switzerland under the Enlargement Contribution for the New EU Member States. The update is mainly intended to provide a baseline for measuring the results of FRTAP activities in the Czech Republic. These activities, which began in 2010, include, *inter alia*, training on the application of clarified International Standards on Auditing (ISAs) for statutory auditors.
- 3 **The original 2003 ROSC A&A report included a number of recommendations in preparation for the Czech Republic's accession to the EU, which it joined in May 2004.** This update evaluates the Czech regulatory framework and related institutions against the EU's First, Second, Fourth, Seventh and amended Eighth Company Law Directives, the European Commission's (EC) Recommendations on Statutory Auditors' Independence and Quality Assurance, as well as the Transparency Directive, the IAS Regulation and the Bank and Insurance Accounts Directives. The Czech Republic graduated as a borrower from the World Bank in 2006.
- 4 The Czech Government understands that high standards of accounting, auditing and corporate governance, aligned with the requirements of the European Union's *acquis communautaire*, contribute to enhanced flows of trade and investment with other countries. Recognizing that the Czech Republic will address the issues identified by this ROSC A&A Update, this report does not contain explicit recommendations.
- 5 **The Czech Republic is a landlocked country located in Central Europe. It has been a member state of the European Union since 2004.** The country has borders with Poland to the north, Germany to the west, Austria to the south, and Slovakia to the east. The capital and largest city is Prague. The Czech Republic became an independent state in January 1993 after Czechoslovakia split into its two constituent parts.

Box 1: Czech Republic Relations with the World Bank

The Czech Republic joined the World Bank in 1993 together with the Slovak Republic, taking over the obligations of the former Czechoslovakia. The Czech Republic graduated from receiving World Bank financial assistance in the spring of 2006; however, it maintains an active partnership with the Bank for technical assistance and analytical work.

Since 1998, the World Bank's assistance to the Czech Republic has evolved towards a focus on advisory services in support of capital and financial market reform; enterprise restructuring; the improvement of fiscal management; improved corporate governance; a better regulatory framework; and pension reform. Some additional activities are continuing in the energy and environment sectors. The collaborative relationship between the Czech Republic and the World Bank has provided opportunities to develop lessons learned and analytical instruments that benefit other countries in the Region as well as the Czech Republic.

As a development partner, the Czech Republic contributes to the International Development Association (IDA), and plays an active role in regional and multilateral institutions.

- 6 **The Czech Republic has a stable population of about 10.5 million.** Its Gross Domestic Product (GDP) per capita is US\$20,407 in 2011; that amount has doubled since 2003, when it was US\$8,950. The composition of the Czech GDP per sector is as follows: agriculture, 2.8%; industry, 37.6%; and services, 60%. Manufacturing is still a significant economic activity, especially the production of automobiles, machine tools, and engineering products. Iron and steel production are still important industries in Moravia, in the east of the country.
- 7 **In 2012 the Czech Republic ranked 65th worldwide with respect to the ease of doing business (Doing Business 2013 Index).** The country has substantially improved its insolvency processes (ranked 34th); and obtaining credit is easier than in many other countries of the world (ranked 53th). At the same time, it lags with respect to barriers to entry into business (ranked 140th); and procedures for paying taxes (ranked 120th). The improvements in the Doing Business rankings for insolvency processes and obtaining credit are partly the result of better quality financial information about company assets and liabilities, which can be traced back to better A&A standards under the EU *acquis*. Procedures for paying taxes could be simplified, thereby reducing the average number of hours needed to prepare income tax returns: at 413 hours per year, the time spent computing taxes for companies in the Czech Republic is two times the average for the OECD.
- 8 **The EU is the largest trading partner of the Czech Republic.** Germany is the leading trading partner, accounting for more than 30% of the country's exports. After 1993, the EU's share of Czech Republic exports exceeded rapidly 65%, and EU member states now provide the largest source of foreign investment in the country.

- 9 **In 2010 the Czech economy started to recover from the 2008-09 downturn, helped by the country's strong economic fundamentals and the recovery elsewhere.**¹ Low public debt, a comfortable external position, the absence of pre-crisis asset bubbles, and a stable financial sector, all helped to moderate the decline in output in 2009, and supported the subsequent recovery. Its close economic integration with the core economies of the Eurozone allowed the Czech economy to benefit from the recovery in trading partner countries, particularly Germany. Net exports led the recovery, followed by rebuilding of inventories, an upturn in private consumption and growth in fixed investment. GDP grew by 2.5 percent in 2010.
- 10 **However, the recovery proved short-lived and the Czech economy moved back into recession in late 2011.** The developing crisis in the Eurozone led to a slowdown in the growth of exports and caused companies to delay their investment plans. At the same time, real household incomes were hit by higher VAT rates – part of government measures to bring down the budget deficit – and efforts to improve the capital strength of the western European banks that dominate the Czech banking system made access to bank credit more difficult. With government spending on infrastructure also being cut, domestic demand fell in 2011 and more sharply in 2012. Economic growth weakened steadily and, although GDP rose by 1.9% over 2011 as a whole, the Czech Republic went back into recession in the second half of the year. The economy continued to shrink in the first three quarters of 2012 and the IMF expects that real GDP will fall by 1% over 2012 as a whole.²
- 11 **A gradual recovery is forecast to start in 2013.** Most forecasters expect that economic conditions in the Czech Republic's main export markets will gradually improve in 2013. This, together with the absence of further significant tax increases, should allow the Czech Republic to emerge from recession during the course of the year. The recovery will initially be weak and even in 2014, the pace of economic growth is likely to be below the economy's potential (the IMF is forecasting GDP growth of 0.8% in 2013, while the European Commission forecasts growth of 0.8% in 2013 and 2% in 2014).³
- 12 Given the constraints facing the banking system and the weak economic outlook in the short to medium term, reforms that can diminish the administrative burden on small enterprises and enhance the relationships between SMEs and prospective investors and bankers, are becoming increasingly important. Initiatives to reassure investors about the quality of financial reporting of public interest entities, including listed companies, banks and insurance companies will also be essential.

¹ Article IV Report, IMF, March 2011

² World Economic Outlook, IMF, October 2012

³ World Economic Outlook, IMF, October 2012 and Autumn Economic Forecast, European Commission, Directorate-General for Economic and Financial Affairs, November 2012

II. Institutional Framework

A. Statutory Framework

- 13 **The Czech Republic has implemented much of the *acquis communautaire* as it relates to accounting and auditing and has refined the deadlines for filing and publishing financial statements, in line with the Fourth Company Law and the Transparency Directives.** In particular, consolidated financial statements are now prepared, adopted and filed at the same time as the separate financial statements of the parent company. Quality assurance and public oversight systems have been established in line with the EU Statutory Audit Directive (SAD). The following paragraphs describe the current statutory framework for accounting and auditing, which is fully compliant with the EU *acquis*: the Czech Republic has not yet implemented the provisions of the Accounting Directives which allow member states to exempt the very smallest firms from various provisions of the Directives.

Legal forms of and governance of companies

- 14 **The Commercial Code regulates the business activities of incorporated entities.** The Code was first enacted in 1991 and subsequently amended to make it consistent with the relevant EU Directives; it was last amended in 2011.⁴ The code recognizes two main corporate forms, which represent the most common legal forms of companies in the Czech Republic:
- **A Limited Liability Company (LLC)** is a company whose registered capital is made up of its shareholders' investments, and whose shareholders are liable for the company's obligations until their paid-up investment contributions are entered in the Commercial Register. A limited liability company may have only one shareholder and requires a minimum registered capital of CZK 200,000 (USD 10,600).⁵
 - **A Joint Stock Company (JSC)** is a company whose registered capital is distributed into a certain number of shares with a nominal value. The company is liable for the breaches of its obligations with all its assets. A shareholder is not individually liable for the company's obligations. A JSC may be established by a single founder (if a legal entity) or by at least two individual shareholders.⁶ The minimum registered capital for a company that intends to hold a public offering of shares is CZK 20 million (USD 1 million); if it does not plan to hold a public offering, the minimum registered capital is CZK 2 million (USD 107,000).⁷

⁴ A new Code of Commerce will be implemented as of January 2014

⁵ Division IV of the Commercial Code governs LLCs.

⁶ Section 162(1) of the Commercial Code.

⁷ Section 162(3) of the Commercial Code.

Table 1: Czech companies by legal form*

| Legal Form | Number of entities |
|---------------------------|--------------------|
| Joint stock company | 24,801 |
| Limited liability company | 335,590 |
| Limited partnership | 752 |
| General Partnerships | 7,233 |
| Cooperative | 15,479 |
| Total | 383,855 |

* Source: ČSÚ Trade Register as of March 15, 2012

- 15 **The general meeting of shareholders (GM) is the supreme body of a company and includes among its responsibilities: (i) deciding on the appointment, removal and remuneration of management and the supervisory board, (ii) approving the appointment of the statutory auditor, and (iii) approving the company's financial statements.**⁸ The GM appoints the statutory auditor, after the recommendation either by the audit committee (in the case of public interest entities) or the management/supervisory board (in non-public interest entities).⁹ The GM must be held at least once a year; the GM that approves the annual financial statements must be held within six months of the end of the accounting period;¹⁰ under specific circumstances, the GM could be held after six months but within the calendar year. JSCs must have a two-tier board; LLCs may choose to have a two-tier board but are not required to do so.¹¹ JSCs have a two-tiered board system, comprising a management board (the executive officers of the company) and a supervisory board (the board of directors). The supervisory board supervises the performance of the management board and is responsible for, *inter alia*, reviewing all financial statements of the company and preparing a report on those financial statements, for consideration by the GM. Supervisory boards must have at least three members; in companies with more than 50 employees, two-thirds of board members are elected by the GM and the remaining one-third by the employees. Members of the management board may not serve on the supervisory board. LLCs are not required to have a supervisory board, although they may establish one if they wish according to their articles of association.¹² The requirements relating to supervisory boards in LLCs are broadly the same as those for JSCs.
- 16 **Companies are required to submit their audited financial statements (legal entity and consolidated, if applicable) and audit report (if applicable) electronically to the**

⁸ Section 125 of the Commercial Code for LLCs, and Section 187 for JSCs. In the case of JSCs, the articles of association may provide for the supervisory board to appoint the management (section 194).

⁹ Section 17(1) of the Auditors' Act. If a company does not have GM or the GM fails to nominate an auditor, the supervisory board is responsible for appointing an auditor.

¹⁰ Section 128 of the Commercial Code for LLCs, and Section 184a for JSCs.

¹¹ Sections 137-140/Sections 197-201 of the Commercial Code set forth requirements pertaining to supervisory boards in LLCs/JSCs.

¹² Section 137 of the Commercial Code.

Commercial Register.¹³ Audited financial statements and the auditor's report must be submitted to the Commercial Register within 30 days of their approval by the GM. Companies submit their financial statements to the Czech National Bank (CNB) when they are subject to its regulation (e.g. banks, insurance companies, listed companies); the CNB forwards the information to the Commercial Register.¹⁴ The Commercial Register is maintained in electronic form and is accessible to anyone online. The Commercial Register will issue a printed and officially verified copy of a document upon request. Financial statements and the annual report are archived with the Commercial Register for ten years.¹⁵

- 17 **Listed companies are required to submit their audited annual financial statements—both legal-entity and consolidated—within four months of the financial year-end to the CNB and the Prague Stock Exchange.**¹⁶ Listed companies are required to submit half-yearly financial statements to the CNB within two months of the financial semester end. Consolidated half-yearly statements must be prepared in accordance with IAS 34, and should include a balance sheet, income statement, statement of changes in equity, cash flow statement, and notes. Separate legal entity half-yearly statements are not required to comply with IAS 34 fully as they must include only a balance sheet, income statement and notes. In addition to the financial statements, listed companies must prepare a report describing important factors affecting business activities and results, as well as information on risks and uncertainties. Half-yearly financial statements do not need to be audited or reviewed. Issuers of listed shares are required to issue quarterly reports, other listed companies are not required to issue them however, they can choose to do so. The annual and semi-annual reports are required to be made available to the public for at least five years.

Accounting requirements

- 18 **The Act on Accounting¹⁷ is the primary legislation regulating accounting and financial reporting, and enacts the provisions set out in the Fourth and Seventh EU Company Law Directives.** It applies to all JSCs and LLCs, including banks, insurance companies, listed companies, and pension and investment funds.¹⁸ The Law and implementing regulations set forth the principles which govern the drawing up of legal entity and consolidated financial statements, state general principles for the valuation of items in the financial statements and specific valuation rules, and list the information that must be provided in each component of financial statements.¹⁹ Entities regulated by the CNB (including listed companies, banks, and insurance companies) (para. 24) are required to follow the provisions in the Act on Accounting; however, they are subject to additional, more stringent requirements, particularly the deadlines for the publication of their financial statements.

¹³Source: Section 21a(2) of Act on Accounting.

¹⁴Source: Section 21a(4) of Act on Accounting.

¹⁵Section 31 of the Act on Accounting.

¹⁶Article 118 of the Capital Market Undertakings Act 7(4) of Exchange Rules, Section III.

¹⁷Act No. 563/1991 Coll., on Accounting, as amended.

¹⁸The Act on Accounting also applies to other entities such as public sector entities that are outside the scope of this report.

¹⁹In particular, Decree 500/2002.

- 19 **According to the Act on Accounting, all companies (and sole proprietorships) are required to prepare annual financial statements (both legal entity and consolidated), including a balance sheet, profit-and-loss statement, and notes.**²⁰ Banks and insurance companies are not required a cash-flow statement. All other companies are allowed to prepare a cash-flow statement and a statement of changes in equity. Audit are required for companies defined as those which meet or exceed one –for JSC’s–, or two–for other business companies, including LLC’s– of the following thresholds for two consecutive years: (a) total assets of CZK 40 million, (b) net turnover of CZK 80 million, and (c) 50 average employees.²¹
- 20 The requirement to prepare financial statements applies to all types of companies and also to individuals who carry out business activities (i.e., "entrepreneurs") and who are included in the Commercial Register. Small companies (i.e., those that are not subjected to mandatory audit as defined above) may draw up abridged financial statements; however, joint-stock companies must always draw up full financial statements, regardless of their size.²² Companies must also follow a mandatory chart of accounts, which prescribes the format and nomenclature of the accounting classes.²³
- 21 **As an exception, companies that are part of a group which uses *endorsed* IFRS for preparing its consolidated financial statements are allowed but not mandated to use *endorsed* IFRS for their legal entity financial statements,** the GM decides on using IFRS or Czech accounting standards for the legal entity financial statements.
- 22 **Although groups of companies are required to prepare consolidated financial statements**²⁴, **small groups are exempted from the consolidation requirements.** Groups of companies are considered small if they fall below two or more of the following thresholds: (a) total assets of CZK 350 million (USD 18.4 million); (b) net turnover of CZK 700 million per year (USD 37 million); (c) average number of employees of 250. However, no listed companies, banks or insurance companies (even small ones) can be exempted from the consolidation requirement.²⁵ Non-listed parent companies may choose between applying Czech GAAP or *endorsed* IFRS in their consolidated financial statements.²⁶
- 23 **The Czech National Bank (CNB) is responsible for supervision of financial sector activities in the Czech Republic.** The CNB supervises the banking sector, the capital market, the insurance industry, pension funds, credit unions, bureau-de-change, and payment system institutions. The range of institutions supervised by the CNB includes:
- 44 banks, which operate in the Czech banking system, with assets totalling US\$204.7 billion (as compared with US\$83.4 billion at end 2002);
 - 52 insurance companies (as compared with 39 in 2002), which underwrote around US\$7.8 billion in policies in 2010 (as compared with US\$2.5 billion in 2002); and

²⁰ Sections 1 and 18 of Act on Accounting.

²¹ Source: Section 18 of the Act on Accounting.

²² Section 18(3) of Act on Accounting.

²³ Section 14 of the Act on Accounting.

²⁴ Sections 22 of the Act on Accounting governs the requirements pertaining to consolidated financial statements; Section 66a of the Commercial Code governs and defines groups of companies.

²⁵ Section 22(3) of the Act on Accounting.

²⁶ Sections 19a and 23a(2) of the Act on Accounting.

- 66 companies listed on the Prague Stock Exchange, with an aggregate market capitalization of US\$67 billion as of the end of 2011. Market capitalization at the end of 2011 was more than four times its level in 2002. However, the number of listed companies fell by 16 per cent over this period.

- 24 **Listed companies are required to prepare consolidated and legal entity financial statements in accordance with *endorsed* IFRS, including a balance sheet, an income statement and a statement of other comprehensive income, statement of changes in equity, cash flow statement, and notes.**²⁷ Companies that are part of a group that uses *endorsed* IFRS for its consolidated financial statements are allowed to apply *endorsed* IFRS for their **legal entity** financial statements as well.²⁸ Companies are also required to keep accounting records in accordance with Czech GAAP for tax purposes (see para. 69) or reconcile their IFRS financial statements to Czech GAAP. In addition to the financial statements and full audit report, listed companies are required to provide information regarding—*inter alia*—policies and procedures for internal controls, executive remuneration, the existence of a company-level governance code (if any), and remuneration of auditors, broken down by type of service, for the issuer and separately for the consolidated group. Management is also required to issue a descriptive report every six months, similar to a Management Discussion and Analysis, or MD&A.²⁹
- 25 **Banks and insurance companies are required to follow the same provisions (with some differences) as general companies when preparing financial statements.** One difference is that banks and insurance companies are required—in addition to preparing a balance sheet, income statement and notes—to prepare annually a statement of changes in equity. The financial statements of banks—both legal entity and consolidated—must be submitted to the CNB and published within four months of the financial year's end.³⁰ Insurance companies must hold a general meeting to approve the company's financial statements within four months of the end of the financial year.³¹ Insurance companies are also required to submit their audited annual financial statements—legal entity and consolidated—to the CNB within 15 days of their publication, and to make their financial statements available to the public.³²

Audit requirements

- 26 **While consolidated financial statements must always be audited, legal entity financial statements must be audited only** if the company exceeds certain size thresholds.^{33 34} JSCs, which—for two successive accounting periods—exceed at least one of the following criteria, must have their financial statements audited: (a) total assets of CZK 40 million (USD 2.1

²⁷ Section 23a(1) of the Act on Accounting.

²⁸ Section 19(9) of the Act on Accounting.

²⁹ Article 119(2)(d) of the Capital Market Undertakings Act (Act No. 256/2004 Coll.)

³⁰ Art. 23(1) of the Act on Banks (Act No. 21/1992 Coll.).

³¹ Art. 82(5) of the Insurance Act (Act No. 363/1999 Coll Act No. 363/1999 Coll Act No. 363/1999 Coll).

³² Article 85(2)a of the Insurance Act.

³³ Other laws may require audits for specific entities.

³⁴ Section 20 of the Act on Accounting.

million); (b) annual net turnover of CZK 80 million (USD 4.3 million), or (c) 50 employees on average. Consolidated financial statements must always be audited, regardless of the size of the company.³⁵ All other companies, which exceed two of the three criteria for two subsequent accounting periods, must have their financial statements audited. Audits are also mandatory for listed companies, banks, insurance companies, pension funds, and investment funds under other specific legal requirements.

Table 3: number of audits mandated by the size of the companies *

| Audit | %* | Number** |
|--|------|---------------|
| Joint-stock companies exceeding the audit thresholds | 27.9 | 6,900 |
| Limited liability companies exceeding the audit thresholds | 2.8 | 10,850 |
| Total | | 17,750 |

* Percentage as of end-2008 (Credit Register)

** Extrapolation based on 2012 statistics (see Table 1)

- 27 **The scope of Public interest entities (PIEs) is defined in the Act on Auditing and is much broader than companies whose securities are listed on an EU regulated market.** It also includes banks, insurance companies, investment funds, companies that employ more than 4000 people, pension funds, the General Health Insurance Company of Czech Republic and other health insurance companies. PIEs are subject to more scrutiny than other companies.
- 28 **Public interest entities (PIEs) are normally required to establish an audit committee.**³⁶ The GM is responsible for appointing the members of the audit committee; however, if the company does not hold a GM, the supervisory board appoints the audit committee. Audit committee members may be members of the company's supervisory board, or they may be external to the company. Audit committees must have at least three members, one of whom must be both independent of the audited entity and have at least three years of practical experience as an accountant or a statutory auditor. Audit committees are responsible for, *inter alia*, overseeing the procedures of compiling annual accounts and consolidated annual accounts, evaluating internal control systems, following the statutory audit process, assessing the independence of statutory auditors, and recommending auditors.

³⁵ Section 22(1) of the Act on Accounting.

³⁶ Public Interest Entities are defined under the Act on Auditing as legal entities whose negotiable securities are accepted for trading on regulated markets in any Member State of the European Union, banks, insurance companies, the General Health Insurance Company, health insurers, pension funds, savings and credit cooperatives, security dealers, the central depository, the operator of the settlement system, investment companies, investment funds, and institutions dealing with electronic money. Public Interest Entities also include commercial companies or cooperatives or consolidated accounting units, if the average converted number of employees of such commercial companies or cooperatives or consolidated units has exceeded 4,000 people over the immediately previous period.

- 29 **Some PIEs that are under the supervision of the CNB can be exempted from establishing an audit committee if they meet the following conditions:** (a) they are not a listed company; (b) the tasks of the audit committee are taken up by the supervisory board; and (c) the company falls below at least two of the following thresholds: (i) 250 employees; (ii) EUR 43 million in total assets; (iii) EUR 50 million in annual turnover. If a PIE has not established an audit committee, it is required to publish which body has taken up the tasks of the audit committee (generally the supervisory board), and who its members are.
- 30 **The GM is responsible for approving the appointment of the statutory auditor in all companies subject to audit.** In the case of PIEs, the audit committee recommends the statutory auditor. If a company or its statutory auditor cancels an audit engagement, they are required to notify the Audit Public Oversight Council (APOC) in writing and include the reasons for such cancellation.
- 31 **Statutory auditors of PIEs are required to take additional measures to assure their independence, including rotating the audit partner at least every seven years.** The key audit partner must rotate every seven years for PIEs, with a two-year cooling off period. During this period that partner is barred from performing audit activities for the entity. On a yearly basis, auditors of public interest entities are required to submit a written statement of their independence to the audit committee of the PIE, as well as notifying the audit committee, in writing, of any auxiliary services performed for that entity. Auditors are also required to discuss potential threats—and measures taken for their mitigation—to their independence with the audit committee. Finally, auditors who perform statutory audits of a PIE may not accept management positions at the entity for a period of two years after concluding the audit. **Banks and insurance companies are required to notify the CNB of the auditor selected for the current year.** The CNB is entitled to reject the auditor within 30 days of receiving this notification if they feel there is due cause (e.g., potential conflicts of interest, lack of experience among other reasons). Resignation or termination of an audit engagement must be reported to the CNB.

Monitoring and enforcement of accounting and auditing and filing obligations

- 32 **The Act on Accounting establishes that companies that do not comply with its accounting, financial reporting and auditing requirements may be subject to fines up to three or six percent of the company's total assets.**³⁷ Companies that fail to prepare, audit, or publish consolidated financial statements are subject to fines up to three or six percent of total assets. The amount of the fine is discretionary and in theory can be very high but, in practice, fines are seldom enforced.

³⁷ A fine up to 6% of total assets applies to companies that, *inter alia*, fail to draw up financial statements or fail to apply IFRS if required to do so. A fine up to 3% of total assets applies to companies that, *inter alia*, draw up incomplete financial statements, fail to have their financial statements audited, or fail to submit financial statements to the Commercial Register. Source: Section 37 of the Act on Accounting.

B. The Profession

- 33 **The implementation of the Statutory Audit Directive by the Act on Auditing proceeded without major issues. However, all stakeholders are still in a learning phase** and statutory auditors still need to get a better understanding of the purpose and objectives of the Statutory Audit Directive. The Czech Republic has not yet fully adopted the EC recommendation on quality assurance, which would require a greater involvement of the APOC. In addition, some issues, such as (i) the independence of the supervisory authorities, (ii) the recognition of auditors' qualifications within the EU, (iii) procedures for setting up inspections, (iv) limits on the scope of the auditor's responsibility, and (v) the *modus operandi* of audit committees, are still a work in progress.
- 34 **The country has two main professional accounting organizations:** The Chamber of Auditors of the Czech Republic established by law (KACR) and the Union of Accountants (UOA), which is a civil association. Both are full IFAC members.

KACR role and governance arrangements

- 35 **Only KACR enjoys statutory recognition, and statutory auditors are required to be licensed members of KACR.** KACR is also a member of the Federation des Experts Comptables Européens (FEE), an EU-based association of professional accountants that groups professional bodies of accountants and auditors in the EU.
- 36 **KACR is the professional organization which licenses statutory auditors.** It was established in 1993 following adoption of the Act 524/1992 on Auditors and the Chamber of Auditors of the Czech Republic. KACR has 1,359 individual members (1,276 are actively engaged in audit work, 83 are inactive). Approximately 45% of the members are practitioners, and 55% are employees. In addition, 368 audit firms are KACR members. Audit firms include local member firms of international audit firm networks, as well as strictly local firms.
- 37 **The law restricted the right to audit financial statements to KACR members only.** The Act on Auditing requires that only persons providing auditing services can be members of KACR and that auditors can only provide legally specified non-audit services in addition to performing audits. The review of KACR activities did not find any key departure from the International Federation of Accountants Statements of Membership Obligations (see Box 2).
- 38 **The Act on Auditing gives KACR the mandate to operate the statutory audit function and enforce its requirements.** Under the law, KACR *inter-alia* (i) maintains the Register of Auditors, (ii) manages the quality assurance system and (iii) designs and operates the pre-qualification, education and programs for Continuing Professional Development (CPD) of auditors. In addition, KACR provides information on request to the CNB about the outcome of quality reviews of auditors who perform statutory audits of entities under the CNB's regulation.

Box 2: KACR Compliance with IFAC SMOs

SMO 1 - Quality Assurance (QA): KACR operates a quality assurance program in compliance with the SAD and clarified ISA requirements. Auditors have been required to comply with the requirements of the clarified International Standard on Quality Control (ISQC1) since 2009. Quality Assurance arrangements are supervised by the Audit Public Oversight Council. The Quality Assurance is managed by the Supervisory Commission and performed by full-time quality controllers, who are non-practitioners employed by KACR.

SMO 2 – International Education Standards (IESs): Statutory auditors follow education requirements in line with the IESs and the Act on Auditing implementing the SAD: they must at least have a bachelor degree, pass selected exams, meet a three year minimum requirement for professional experience, and are required to participate in a 40-hour CPD program each year. KACR organizes (i) preparatory courses for initial education, (ii) exams, and (iii) CPD.

SMO 3 - International Auditing and Assurance Standards (IAASB) pronouncements: Since 2006, auditors provide audit and assurance services in compliance with clarified ISA and other relevant IAASB pronouncements.

SMO 4 - International Ethics Standards Board for Accountants (IESBA) Code of Ethics: KACR has adopted the revised IESBA Code of Ethics, issued in July 2009, and its provisions became effective on January 1, 2011. KACR supported its implementation with a series of publications and training courses.

SMO 5 - International Public Sector Accounting Standards (IPSAS): A significant number of KACR members provide services to public sector entities; they are supported by a technical committee that publishes application guides on public sector accounting and auditing. KACR cooperates with the Supreme Audit Office and with MoF in the application of and compliance with IPSAS.

SMO 6 - Investigation & Discipline: KACR is running an investigation and disciplinary system through the Supervisory and Disciplinary Commission, composed of elected members. The APOC, established in May 2009, implements the requirements of the Act on Auditing, and reviews the operations of KACR. The APOC also acts as an appeals body, when an auditor disagrees with a decision made by KACR.

SMO 7 - International Financial Reporting Standards: Entities listed on a regulated market are obliged to prepare financial statements and consolidated financial statements in accordance with the IFRS, as endorsed by the EU.

- 39 **KACR's governance structure is established by the Act on Auditing** and consists of the Assembly (convened bi-annually), the Executive Committee, the Supervisory Committee and the Disciplinary Committee. Members of the Committees are elected by the Assembly, and those who are elected are limited to a maximum of two consecutive terms of four years in each KACR function.

- The Executive Committee is the executive body of the Chamber; it is chaired by the President of the Chamber and has 14 members (all committee chairs are automatically members of the Executive Committee; the terms are staggered such that half of the Executive Committee members are up for reappointment or replacement every two years)
- The Supervisory Committee is the controlling body of the Chamber, and manages the quality assurance system. It has 11 members.
- The Disciplinary Committee has 7 members.

40 **Several other committees, which support the operations of KACR, are managed by the Office under the Executive Committee.** A Presidium, which consists of the President, two Vice-presidents and the Chief Executive of the Office, assist the Executive Committee with operational issues. The main functions of this group of committees, relevant to the audit profession, are as follows:

- **The Audit Examination Committee**, in cooperation with the Education Committee of APOC, (i) prepares audit examinations and proposes members of the examination commission, and (ii) develops textbooks and the content of pre-qualification courses;
- **The Professional Administration Committee** processes registration applications from auditors and audit firms, manages the registers, monitors the practical experience of members, and deals with ethical issues;
- **The Technical Committee** issues audit guidance and interpretation of ISA;
- **The ISA Translation Board** is responsible for translating the ISAs. It has 10 members drawn from the Big 4 audit practices, SMPs, as well as academia. Translations are made in accordance with relevant IFAC policies;
- **The Continuous Professional Development (CPD) Committee** organizes CPD and professional conferences.

41 **Other KACR committees and working groups can provide inputs on financial reporting issues in addition to other stakeholders:** KACR can provide comments on accounting laws and Czech GAAP to the Ministry of Finance and to the National Accounting Council (NAC). These committees and working groups issue interpretations of NAS, and monitor developments in IFRS as well as legal developments related to financial reporting in the financial sector, in cooperation with the CNB and the PSE.

The Quality Assurance System

42 **The Act on Auditors stipulates that KACR is responsible for audit quality control, while the APOC monitors KACR's performance of this function.** The APOC also initiates inspections and is entitled to participate directly in inspection work.

- 43 **The Czech Republic did not yet adopt fully the EC Recommendation on external quality assurance** for statutory auditors and firms that audit public interest entities (2008/362/EC). The perception is that the current system functions satisfactorily. While there were some auditing failures in the Czech Republic since the financial and business scandals of the late 1990s they were not significant with one exception. A few instances of business failures involving clean audit opinions were recently publicized, and subsequently acted upon by the APOC and KACR; the results of these actions are not known as of the date of completion of this report.
- 44 **Quality Control is managed and conducted by KACR's Supervisory Committee with the support of its inspection department.**³⁸ To accomplish this, KACR employs 6 staff inspectors who lead the inspections, who are supported by eleven practitioners who provide technical support. Members of the inspection department receive annual training.
- 45 **An important tool for quality reviews is an updated "Framework Questionnaire", which was approved by the Supervisory Committee in December 2011.** The questionnaire includes questions, based on *clarified* ISA, which cover all ISA. It represents an improvement over its predecessor in that its focus is on assessing whether sufficient and appropriate evidence was obtained and documented in conducting the audit, and whether the audit complied with applicable laws and regulations.
- 46 **The review process includes a grading system, based on comparing the reviews of several audit files (in general two to four).** Once the review has been completed, the final report is signed by the reviewers and the auditor. It is then discussed by the Supervisory Committee, which decides on "grades" for the auditor's performance and compliance with KACR membership obligations. The grading is done on a scale from A (excellent) to D (poor) for audit quality and on a scale from 1 (excellent) to 4 (poor) for the auditor's compliance with membership obligations (CPD, fees, liability insurance, etc.).
- 47 **Intervals between quality reviews of auditors and sanctions are based on the grades accorded by the Supervisory Committee.** For example, a grade A1 means that the next quality review will be held in three years' time for a PIE auditor or six years' time for a non-PIE auditor; a grade C3 results in a one to two-year interval; and a grade D4 automatically results in a disciplinary procedure. In addition, the Supervisory Committee receives a summary of relevant media coverage on a monthly basis, which may lead to an unscheduled, immediate quality review.
- 48 **The number of mandated reviews due to be performed in any given year challenges the capacity of KACR, which has limited human resources and thus limited capacity to perform reviews.** The Supervisory Committee has established that more than 235 quality reviews need to be conducted annually to sustain the three-year (auditors of PIEs) and six-

³⁸ The Act on Auditors states, in para 24.2 that, "The system of quality control is organized and managed by the Chamber in accordance with the oversight regulation, which is an internal document of the Chamber, and which also sets out the details of the quality review performance by individuals in accordance with para 3.d and the process of quality review completion."

year (non-PIE auditors) cycles.³⁹ Table 4 shows the number of reviews conducted annually during 2007-2011.

Table 4: Breakdown of Quality Reviews

| Year | Audit Firms | Sole Practitioners | Total |
|------|-------------|--------------------|-------|
| 2007 | 41 | 30 | 71 |
| 2008 | 82 | 45 | 127 |
| 2009 | 109 | 76 | 185 |
| 2010 | 93 | 112 | 205 |
| 2011 | 151 | 97 | 248 |
| 2012 | n/a | n/a | 239 |

- 49 **The 2010 and 2011 reviews found instances of poor compliance with ISAs in all areas of auditing, mostly among small practices.** In many instances, non-compliance occurred when the audits were conducted by smaller audit firms that often lack the resources to keep up with audit requirements. Instances of non-compliance include: unclear or incomplete terms of engagement (ISA 210); poor documentation of the auditor's work (ISA 230); inadequate audit evidence and evaluation of the risk of fraud (ISA 240); weak audit planning (ISA 300); inadequate risk assessment procedures (ISA 315, 330); inappropriate determination or omission of the level of materiality (ISA 320); inappropriate evaluating of audit sampling (ISA 530); incomplete written representations (ISA 580); and, audit evidence that was inadequate to provide a basis for expressing an opinion (ISA 500, 700).

Table 5: Disciplinary Committee Rulings

| Year | Total rulings | Reprimand | Public Reprimand | Fine (CZK 000') | Suspension | Cancellation | Average sanction (CZK 000') |
|-------|---------------|-----------|------------------|-----------------|------------|--------------|-----------------------------|
| 2009 | 30 | 11 | 0 | 394 | 0 | 0 | 21 |
| 2010 | 20 | 1 | 0 | 600 | 3 | 1 | 40 |
| 2011 | 41 | 4 | 9 | 1,802 | 5 | 1 | 82 |
| 2012 | 53 | 3 | 6 | 2,414 | 8 | 0 | 67 |
| Total | 144 | 19 | 15 | 5,210 | 16 | 2 | 210 |

³⁹ Para 24 of Act 93/2009, Coll., on Auditors requires that auditors of public interest entities are subject to quality review in three-year cycles, other auditors in six-year cycles.

Auditors' liability

- 50 **Even though the Act on Auditors requires that all auditors carry liability insurance commensurate with their potential liability, Czech legislation does not specifically deal with auditors' liability.** Damages resulting from negligent professional services or lack of due care are covered, in general, by the Civil, Commercial and Criminal Codes. The plaintiff may initiate judicial proceedings against the audit firm and against any or all of the auditors (individuals) who have participated in the audit services (joint and several unlimited liability). There have been no landmark court cases involving audit failure in the Czech Republic; all disciplinary cases so far have been dealt with by KACR's Disciplinary Committee.

The Union of Accountants

- 51 **The Union of Accountants (UOA) is a voluntary professional organization of Czech accountants, established in 1990.**⁴⁰ It is the successor body to the Czech Union of Accountants and Statisticians, which was established in 1969. UOA has approximately 6,000 members; the membership includes *inter alia* bookkeepers, accountants, auditors, and tax consultants. It consists of 17 local branches, each enjoying broad autonomy from the head office, particularly concerning matters of education and governance. One of the 17 branches, the "Chamber of Certified Accountants (CCA), consists mainly of individuals who completed the professional certification program. UOA requested exemptions from several of IFAC's SMOs, including SMO 1 – Quality Assurance – and SMO 4 - International Ethics Standards Board for Accountants (IESBA) – on the basis that its membership and governance structure does not enable effective implementation of those SMOs.

C. Professional Education and Training

- 52 **Professional Education and Training has greatly improved since the previous ROSC.** KACR has strengthened its certification program, which is now compliant with both the Statutory Audit Directive and IFAC's International Education Standards, including Continuing Professional Development requirements. The Union of Accountants assisted the development of the CCA, which operates a certification program inspired by the English Association of Chartered Certified Accountants (ACCA).
- 53 **Requirements for obtaining an audit license include initial education requirements and professional experience in line with SAD and the IESs.** The requirements for obtaining an audit license from KACR are set out in the Act on Auditing in line with the SAD. To obtain an audit license from KACR an individual must: (i) obtain a bachelor or a master degree recognized in an EU Member state; (ii) have legal capacity and demonstrated integrity; (iii) possess three years work experience in auditing, and (iv) pass the professional exams

⁴⁰ Czech language uses one term, "účetní," for both "accountant" and "bookkeeper." Although attempts have been made to distinguish between the two professions, none of the proposed solutions was widely adopted. The Union of Accountants caters to both bookkeepers and accountants.

organized by KACR. In addition to these requirements candidates must not have overdue tax and other statutory liabilities.

- 54 **KACR operates the professional education and certification program, whose topics are in line with EU requirements** and includes the following courses: business combinations and consolidated financial statements, business finance; business law; information systems and statistics; auditing (I and II); financial accounting; management accounting; microeconomics; macroeconomics; and taxation: The exams must be completed within three years from the first registration.
- 55 **KACR has increased the number of equivalences between its own qualification system and the system of the UK based Association of Chartered Certified Accountants (ACCA).** KACR entered into an agreement with UOA and ACCA to recognize certain exams as equivalent to their own. KACR with other professional bodies observes a process of mutual recognition or partial recognition of examinations passed by candidates. This is a critical step for many staff members of local member firms of international network who have been trained on the basis of ACCA-based programs (these audit firms often require their staff to go through the ACCA exams as this accountancy qualification is recognized in many regions of the world, including in central Europe). At end-February 2012, ACCA had 1,327 individual and 24 corporate members and 2,970 individuals who were either certified or in various stages of certification in the Czech Republic.
- 56 **UOA has developed its own certification program, which is operated by the Institute for the Certification of Accountants (ICU) (a private firm).** UOA and ICU have entered into a long-term contract to implement this program; ICU was established in 2002. This certification program consists of 13 examinations, originally designed with assistance of ACCA. Professional accountants, who successfully pass all ICU exams of a two-stage certification program (certified accountant and accounting expert) or are members in good standing of a similar foreign association, may request the certificate from UOA.
- 57 **There are other significant private sector education institutions that offer the ACCA qualification program.** These institutions offer programs in addition to those run by professional bodies. The ACCA qualification program has been remarkably popular in the Czech Republic. Currently, there are 835 ACCA-qualified individuals and more than 1,500 students. In addition to the exemptions granted to the members of other professional bodies, ACCA grants three to five exemptions to graduates in Economics from two state universities in Prague and one private university.
- 58 The exemptions granted by the above-mentioned professional bodies are summarized in the table below:

| Exemptions Granted | By KACR | By ACCA | By UOA |
|-----------------------|---------|---------|--------|
| For KACR exams | - | 3 | 10 |
| For ACCA exams | 4 | - | all* |
| For CCA exams | 4 | 8 | - |

**Oral interview only required for ACCA members to become CCA-qualified*

- 59 **In addition, KACR grants several exemptions (up to nine, with the exception of Auditing II) to university graduates who have passed relevant university examinations.** The exemption policy and the list of courses applicable for exemptions (for the University of Economics, only) are available on the KACR website. For universities other than the University of Economics, the student requesting an exemption must attach the relevant syllabus to the request. The request is then processed by a committee appointed by the APOC and decided upon by the KACR Executive Committee.
- 60 **Although the SAD foresees equivalences between professional qualifications in EU Member States** there is only one foreign auditor operating in Czech Republic, who is from the U.K.

Continuous Professional Development

- 61 **KACR members are required to maintain their competence through participation in the Continuing Professional Development Program (CPD),** the structure, content, and organization of which is managed by the KACR Institute for Audit Education.
- 62 **The annual minimum for auditors is 40 hours of CPD. Recognized CPD units include attending or giving training programs, publishing research, and e-learning.** Where the auditor has not met the minimum of 40 hours of annual CPD, the missing number of hours is added to the 40 hours required for the following year.
- 63 **If an auditor has not met the CPD requirement for two successive years, the Institute reports it to the Disciplinary Committee for further action.** Where the auditor exceeded the annual minimum of 40 hours, 50% of the excess, up to a limit of 20 hours, is carried over to the following year.
- 64 **Every auditor is required to submit an annual CPD declaration by January 31 of the year following the year to be reported,** and KACR has the right to request evidence proving participation at CPD events. However, since the Institute for Audit Education also maintains participation records, an auditor is not required to submit the declaration of participation in Institute events. **CPD results are published annually in the Auditor magazine published by KACR.** Publication includes the names of those members who failed to submit the declaration by the January 31 deadline. KACR's Supervisory Committee monitors the participation of auditors in CPD programs, as well as their compliance with the CPD regulation of KACR.

D. Setting Accounting and Auditing Standards

- 65 **The standard setting system for accounting in Czech Republic consists of a two tier legal system** whereby the accounting law and corresponding decrees that implement the requirements of the Fourth and the Seventh Company Law Directive coexist with Czech Accounting Standards. Czech Accounting Standards are merely bookkeeping instructions needed to account for a specific transaction. One notable exception is the standard on

financial instruments, which closely resembles the classification and measurement requirements of IAS 39 – Financial Instruments. The corpus of Czech Accounting Standards texts will be referred to as Czech GAAP in the remainder of this report.

- 66 **The income tax base and profits for reporting purposes are closely related, requiring few adjustments, but some exceptions apply that add complexity to the system.** The adjustments mandated for calculating the tax base concern: (i) non-deductible costs, (ii) differences between accounting and tax depreciation, and (iii) income not subject to corporate tax. The tax base is then adjusted for accumulated tax losses carried forward, research and development allowances, and gift to charities. The close link between financial reporting and tax accounting is a key element for keeping the administrative burden related to the tax declaration bearable. The authorities believe that this close link is made possible by their approach to accounting which relies on the legal form of transactions: In contrast to International Financial Reporting Standards, the substance over form principle is not considered in Czech GAAP. The ROSC team understands that some revenue recognition and other sectoral exceptions make the system more complex.
- 67 **The Ministry of Finance (MoF) is the "standards setter", as it drafts accounting and auditing laws and issues implementing decrees and accounting standards.** The MoF is also responsible for setting the accounting standards for the public sector. In the last three years, the MoF has largely focused on public sector accounting and has issued only minor amendments to the accounting law for the private sector. However, in December 2011, the accounting law was amended with regards to: (i) reevaluation of assets in the case of a company transformation, (ii) obligation to net the income tax due with the tax paid in advance, previously posted as a prepaid asset, and (iii) new restrictions on provisions for repairing an asset when the component approach has been adopted.
- 68 **The principle of substance over form is not considered in the Czech Republic, which follows a very legalistic approach to accounting.** The tax authority follows very closely changes in accounting procedures, and the tax base is linked to the accounting used to report profits. The tax authority recognizes that tax is no longer the main driver of accounting standards, which now need to be linked with the requirements of the EU's accounting directives and are based on IFRS. The Czech Republic has even adopted the true and fair override principle in the Fourth Company Law Directive.
- 69 **The MoF uses an advisory committee to consider changes in the law requested by users and accounting professionals. The MoF's aim is that changes to laws and standards are not only driven by changes in EU legislation, but also meet the needs expressed by the main stakeholders of financial reports.** The advisory committee has four different subcommittees: tax, consulting and auditing, private sector accounting and public sector accounting. The Minister of Finance appoints subcommittees' members annually, and the First Deputy Minister appoints members of subcommittees. The committee for the development of accounting and auditing meets usually once a year.
- 70 **The consultation process to review draft laws includes professional bodies and academics as well as ministries and public agencies.** Draft laws and decrees are reviewed within the government and the CNB, and are then shared with the National Accounting Council and its constituency: KACR, the UOA, the University of Economics, Prague and the Chamber of Tax Advisers. The MoF must address all comments made during the review

process. The MoF can also consider including a formal review by its advisory committee in the consultation process when it drafts new laws and standards.

- 71 **Czech Auditing Standards were replaced by ISA in 2006.** KACR is responsible for issuing auditing standards, and translating and publishing ISA. With the assistance of the World Bank, the Chamber is currently carrying out a large-scale program to train auditors in the new *clarified* ISA. This represents a major improvement from 2003 when Czech Auditing Standards fell below the levels of International Standards on Auditing.

E. Enforcing Accounting and Auditing Standards

Audit Public Oversight Council's role and governance

- 72 **The APOC is a young institution which has established its position on the map of the Czech accounting and auditing landscape.** When it was established, the APOC sought close cooperation with KACR in playing its role in overseeing statutory audits and auditors' activities. As an example of this cooperation, a key member of the APOC, who is also a member of KACR, reviews the quality assurance operated by KACR (the Act on Auditing permits one member of the APOC to be an auditor). This close collaboration with KACR is seen as having enabled the APOC to begin operating quickly. Over the longer term, however, such close links with KACR pose a risk that the APOC will be perceived as not being sufficiently independent of KACR's influence.

Box 3: Annual Report 2011 of the Audit Public Oversight Council

The report describes the activities of the Council's Presidium and committees: meetings, operations, findings, and conclusions. The report does not include any executive summary.

The Council's Presidium supervised the activities of APOC's committees, reviewed their findings and conclusions. In particular, the Presidium reviewed the activity of the Committee responsible for monitoring audit quality assurance, the results of the quality assurance inspections of the Supervisory Commission hosted by KACR, and the involvement of APOC in individual inspections.

The Committee for Monitoring the Quality Inspection System and for Disciplinary Procedures discussed (i) the oversight of the audit quality assurance inspections, and (ii) the oversight of the application of disciplinary measures; it reviewed the reports on the results of the quality assurance inspections. The annual report includes summary results of the quality assurance inspections and details about the participation of members of the Committee in these inspections. The names of the companies reviewed are not disclosed. The summary reports on audit quality assurance are also available on KACR website.

Box 3: Annual Report 2011 of the Audit Public Oversight Council (Continued)

The Committee for Coordination of Training and Professional Examinations reviewed (i) the content and delivery of courses and exams managed by KACR, (ii) requirements for entering the audit profession, and (iii) appeals against KACR regarding the absence of recognition of partial exams taken by students. The Committee found the content of the courses and exams to be satisfactory.

The Committee for Cooperation and Coordination of Audit reviewed EU and country level legislative proposals, including draft amendments to the Act on Auditors and the consequences from other Czech legislation on audit activities and oversight. It also discussed the EC recommendation on quality assurance; the Committee proposed not to change the current organization of the quality assurance process, which is managed by KACR and under the oversight of APOC.

The Controlling Committee monitored the compliance of APOC with its financial obligations, including its expenses and accounting records. It did not issue any new recommendation in 2011.

- 73 **The system of Public Oversight of statutory audits and auditors represents a compromise that is not fully in line with EU recommendations on quality assurance.** There is a risk that the system will need to be further modified to meet the EU Recommendation and in light of the EC's proposals for a new SAD and Regulation.
- 74 **The APOC is managed by a Management Board, whose members are appointed by the Minister of Finance in consultation with the CNB.** The Management Board includes users of auditor's services, academics, accountants, auditors and regulators.
- 75 **The APOC oversees auditing activities as well as those KACR activities defined by the Act on Auditing.** According to the Act on Auditing, the APOC is mandated to take into consideration the protection of the public interest. The statutory obligations of the APOC include monitoring compliance with (i) the provisions of the Act on Auditing, (ii) Auditing Standards, (iii) the Code of Ethics, (iv) the internal regulations of the Chamber by auditors and by the various bodies of the Chamber; (v) the organization, management and operation of the system of quality control of audit activities performed by the Chamber; (vi) the system of continuous education of statutory auditors organized by the Chamber; and (vii) the sanctions and discipline system.
- 76 **The APOC also cooperates with the regulatory and supervisory institutions to enhance the effectiveness of statutory audit.** APOC cooperates (i) with the Ministry of Finance in the drafting of legislation related to statutory audits; (ii) with the authorities in charge of public supervision over auditors from the other EU Member States and from third countries; (iii) with the CNB in supervising auditors conducting audits of entities under CNB's supervisory regulation; and (iv) act as the appeals body to KACR decisions, including for any unresolved quality control or disciplinary issues in the KACR.
- 77 **In overseeing KACR's activities, the APOC reviews any new or proposed amendments to internal regulations, prior to their approval by the Assembly or the Executive**

Committee. APOC staff and managers are allowed to attend – without the right to vote – sessions of KACR's Assembly or its committees; the APOC may make proposals to KACR or suggest amending or removing internal regulations, if those proposals contradict the current Act or any other legislation; if KACR fails to uphold such move within a time indicated by the APOC, the Council may file an action with a court of justice to modify or eliminate that internal regulation;

- 78 **Specifically as regards quality assurance, the APOC's role is among other to approve KACR's plan for quality control and supervise its execution.**⁴¹ The basic provisions of the quality assurance system are specified in the Act on Auditing; they are further detailed in the quality assurance regulations set by KACR and approved by its assembly. The annual plan for the audit inspections is prepared by the Supervisory Commission of KACR and approved by the APOC. According to the provisions of the law and the Directive, the performance of auditors of PIEs is to be reviewed at least once in three years. Auditors for whom an inspection reveals poor quality must have their work reviewed again within a shorter time frame.
- 79 **The APOC also monitors the professional education system and analyzes requests to appeal adverse rulings by KACR.** Claims received by the APOC often relate to professional exams, and whether specific exams satisfy registration or CPD requirements. Several claims involve whether a qualifying exam passed at a university or administered by another professional association should be recognized.
- 80 **The APOC does not directly impose sanctions under the current Act on Auditing.** KACR is responsible for imposing sanctions on auditors who fail to observe their professional obligations, such as mandatory CPD requirements, paying their membership fees or who demonstrate inadequate work as revealed by the inspection process. Usually, the sanctions are limited to reprimands and/or fines; however, severe sanctions such as the temporary or permanent prohibition to provide audit services have occasionally been imposed.

Role of the CNB

- 81 **The CNB is an integrated supervisor; however, it is not legally responsible for enforcing accounting and auditing requirements.** It supervises the banking sector, the insurance sector, the pension sector, other regulated entities such as investment firms and fund managers, as well as companies whose securities are listed on a regulated market. Off-site supervision units of CNB are responsible for reconciling reported financial statements of companies under its supervisory regulation with their prudential returns and prospectuses issued to the general public.

⁴¹ The audit quality review process is based on a questionnaire that covers all *clarified* ISA and is managed by the Supervisory Commission at KACR. It includes a grading of the auditor's performance and compliance with KACR membership obligations that determines sanctions applied to the auditors and intervals to the next review (see discussion under paras 41-48)

- 82 **Banks and insurance company prudential returns are compared to their audited financial statements four months after year-end.** For banks and insurance companies, prudential reports are based on the same accounting systems as their published financial reports; however, the level of disaggregation differs substantially between these categories of reports.
- 83 **Since 2010, the CNB has been piloting an initiative to review the IFRS-based financial statements of listed companies.** The CNB reviews a few sets of financial statements each year, using a checklist prepared by the European Securities Market Authority, which coordinates the activities of all securities supervisors in Europe. The checklist is similar to the one used by audit firms for reviewing the completeness of disclosures by companies that use IFRS in preparing their financial statements.

III. Accounting Standards as Designed and as Practiced

- 84 **Although the Czech government has transposed the Fourth Directive and other elements of the *acquis communautaire* into Czech legislation, the accounting and auditing profession is requesting more changes to align Czech accounting more closely with *endorsed* IFRS.** The legalistic view of accounting for leases transactions is an example where Czech GAAP does not allow the lessee to account for a fixed asset under a financial lease. In fact, operating leases and financial leases have the same accounting treatment under Czech GAAP, **whereas repo transactions are accounted in line with IAS 39.**
- 85 **The National Accounting Council issues interpretations of Czech Accounting Standards,** which though not legally binding, aim to guide professionals in applying the relevant laws and accounting standards. The National Accounting Council was set up originally by four organizations in January 1999: the Union of Accountants, the Chamber of Auditors of the Czech Republic, the Chamber of Tax Advisors of the Czech Republic, and the Prague School of Economics. The interpretations of the National Accounting Council are not part of accounting legislation and subsequently are not binding.

The Standard Gap

- 86 **The main differences of principles between the Czech GAAP and IFRS are those that concern the EU Fourth Company Law Directive, excluding its provisions linked to the IAS Regulation.** The principle of substance over form is not part of Czech GAAP and some accounting treatments are not harmonized with IFRS, such as accounting for leases.
- 87 **The accounting differences between the Czech GAAP and *endorsed* IFRS mainly affect the enterprise sector.** Most banks prepare their financial statements using *endorsed* IFRS or Czech GAAP. Czech GAAP have been made closer to IFRS for banks than for the enterprise sector. For instance, the Czech Standard on Financial Instruments has been drafted to meet most the provisions of IAS 39. Most insurance companies still publish their financial statements using Czech GAAP.
- 88 **Selected differences include the following:**
- **Components of financial statements:** Under Czech GAAP, all private companies may elect not to prepare a statement of cash-flows and, except for banks and insurance companies, a statement of change in equity. In addition Czech GAAP prescribe financial statement formats, as indicated in the EU Accounting Directives. The concept of statement of comprehensive income is not introduced in Czech GAAP.
 - **Absence of restatement of prior year financial statements for a change in accounting policy or a correction of error:** Until 2012, changes in accounting principles and correction of errors were accounted for through the income statements under Extraordinary Items, which is prohibited under IFRS. Because the previous year figures cannot be restated, changes were put through the income statement. This is

linked to a provision of the Act on Accounting that financial statements cannot be modified after the GM has approved them. Financial institutions correct their prior errors through a restatement of the opening balance of retained earnings for the current period – extraordinary items are defined to include operations that are not current activities of a company. Changes in accounting policies or correction of errors must be described in the annex. From 2013 a new system of reinstatement is introduced that will imply that current year results will no longer be impacted by prior years errors.

- **Impairment of Goodwill:** Under IFRS goodwill is subject to impairment but is not amortized. Under Czech GAAP goodwill is amortized over a default period of five years, if a more appropriate amortization period cannot be ascertained reliably. Negative goodwill is subject to a similar treatment: it is recorded as an amount offsetting assets, and amortized over a period of five to twenty years. Under IFRS negative goodwill is accounted as a profit and positive goodwill is not amortized, but subject to annual impairment.
- **Czech GAAP do not endorse the substance-over-form qualitative characteristic set out by the IFRS Conceptual Framework.**⁴² Transactions and other events may be accounted for and presented in their legal form, but not in accordance with economic reality. The consequence mainly for the enterprise sector is that in certain instances, the accounts reflect more of a legalistic view of transactions rather than their commercial substance. Although Czech GAAP are fully aligned with the *acquis communautaire*, this has impeded progress in two areas where commercial substance is of paramount importance: (i) consolidation of Special Purpose Entities, (ii) recognition of leased assets by the lessee under financial leases:
 - **Special purpose entities.** The legal status of the entity prevails. SPEs are not consolidated based on the risk and reward that entity would bear, but only on who controls it legally. Czech GAAP now requires that these SPEs, when they meet the risk and reward criteria, be disclosed in the notes.
 - **Finance leases:** Czech Accounting Standards do not require that financial leasing transactions be presented in accordance with IAS 17, Leases. The legal form prevails over the commercial substance; and there is thus no difference in accounting for an operating lease or a financial lease. For the lessor the leased assets are capitalized and depreciated. Revenue is accrued over the lease term on a straight line basis.
 - The Act on Accounting however provides a true and fair view override, in line with the requirement of the Fourth Company Law Directive, which could be used as an argument to comply with the substance-over-form principle.
 - **There are specific differences between Czech GAAP and IFRS for financial sector companies, including insurance companies.** The practice is that most banks publish financial statements using *endorsed* IFRS. Czech GAAP pertaining to

⁴² The compliance gap seeks to identify the main differences of Czech GAAP with full IFRS that includes the IFRS Conceptual Framework which has not been adopted by the EU.

insurance companies are primarily set out in the Act on Accounting, supplemented by Decree No. 502/2002 Coll. One example of insurance company accounting treatment is that they record available-for-sale securities in the income statement and held to maturity securities are fair valued through equity.

Observed Practices

- 89 **The ROSC team reviewed a selection of financial statements to assess the compliance gaps with IFRS as endorsed by the EU and with Czech GAAP.** The ROSC team selected IFRS-based financial statements prepared by 2 enterprise sector companies listed on the PSE, as well as 2 banks and one insurance company; and Czech GAAP-based financial statements were prepared by 15 companies in the enterprise sector; Czech GAAP-based financial statements were sourced at the Commercial Register.
- 90 **Overall the standard of IFRS reporting was carried out to a high standard by the banks, the insurance company and one company of the industry sector.** In view of the nature of the activities of the companies whose financial statements were reviewed, the policy notes were lengthy and clearly intended to be comprehensive. The reviews of financial statements of the financial sector companies focused on the measurement and disclosure in relation to financial instruments, and concentrated on compliance with IAS 39 'Financial Instruments: Recognition and Measurement' and IFRS 7 'Financial Instruments: Disclosures'. Of particular emphasis in the reviews were the accounting policies for impairment, valuation of financial assets, risk disclosures and, where relevant, hedging both under IAS 39 and economic hedging. Compliance with the remaining IFRSs that are relevant to a company was also reviewed.
- 91 **One set of IFRS consolidated financial statements prepared by a company in the enterprise sector did not comply with IFRS.** The company had written off 75 per cent of trade receivables, representing 73% of its pre-tax profit, without providing an explanation or a schedule for the movements of provisions. Also, the revenues of several business segments were presented under segment reporting, but the statements did not include information on assets and liabilities by segment.
- 92 **In contrast, the review found that 15 financial statements prepared under the Czech GAAP were of uneven quality.** These financial statements were taken from the Commercial Register and cannot represent the overall quality of implementation of Czech GAAP in the Czech Republic, however it can provide some information to the national authorities to help them better enforce accounting standards and filing regulations. Some of the financial statements were incomplete; and, in a few instances, audit reports were missing. The lack of quality varies from missing audit reports to incomplete disclosures.

IV. Auditing Standards as Designed and as Practiced

- 93 **Czech Auditing Standards were replaced by ISA in 2006. KACR is responsible for issuing auditing standards, and translating and publishing International Standards on Auditing.** With the assistance of the World Bank, the Chamber has introduced a large-scale program to train auditors in the new *clarified* International Standards on Auditing funded by the Swiss Contribution. This represents a major improvement from 2003 when Czech Auditing Standards fell below the levels of International Standards on Auditing.
- 94 **The review of financial statements did not enable the team to identify issues about ISA implementation.** When published, audit reports reviewed were of good quality. All the reports reviewed provided for clean opinions, and two of them included an emphasis of matter. However the size of the sample does not allow any general conclusions about the quality of implementation of auditing standards to be drawn.
- 95 **The quality of ISA implementation as reviewed by the KACR quality assurance team is higher among member firms of international networks.** The quality assurance team, which currently reviews statutory audits, finds a correlation between the size of the audit practice and the quality of audits. Typically member firms of international audit network have a better record for performing quality audit under ISA. To some extent the review of financial statements found that the quality of financial information under IFRS and Czech GAAP was better when audited by the bigger firms.

V. Perception of the Quality of Financial Reporting

- 96 In, 2003, the ROSC concluded that there was little evidence that a large demand for transparent financial statements had developed among potential investors. The low demand for financial statements was compounded by the perceived lack of reliability of financial information, and the fact that most funding of businesses was provided by local banks relying on personal relationships or collateral or by delaying late payments to creditors.
- 97 **The quality of financial reporting is perceived to have improved for companies subject to the IAS Regulation.** The quality of financial statements has developed for listed entities based on two pillars: (i) in 2005, all entities that issue securities on a regulated market were required to maintain their accounts and report their consolidated and legal-entity financial information using *endorsed* IFRS, and (ii) subsidiaries of international companies that have their parent company in another EU member state (where they comply with more mature supervisory regimes) provide reliable and informative financial information based on IFRS.
- 98 **For companies preparing their financial statements using Czech GAAP, accounting and auditing professionals believe that the calculation of the net profit, which serves as the basis for calculating income tax, is generally of good quality. However, the quality of disclosures is often substandard.** Interviews with representatives of various users of corporate financial information revealed a shared conviction that SMEs either do not publish information at all or minimize its content by making it as blandly boiler-plate as possible. Two main reasons are evoked by stakeholders. First, there is a perception, especially among the SME sector, that publication would provide information that competitors or clients could use to harm the firm's position. In particular, in the very competitive automotive industry, parts manufacturers are very uncomfortable about providing information that could influence price negotiations with their clients. Second, as noted above, there is a broad absence of enforcement of publication requirements. In some other European countries, penalties for not filing financial statements in time are triggered very quickly.
- 99 **Many companies that are not listed do not file their financial statements on time, which in turn impedes their publication.** When selecting reports for analysis in February 2012, the team noted that two out of three companies had not filed their 2010 financial statements. This is further corroborated by a study, published by UOA in June 2012, which found that less than 30% of the companies actually filed their financial statements.

VI. Areas for Consideration

- 100 **Accounting and Auditing Framework: Raising the accounting and reporting thresholds for small companies and alleviating the reporting obligations for micro-entities.** Small and micro-entities are constrained by limited resources and cannot comply with demanding reporting requirements. Those requirements place a burden on them, which is not always proportional to their size and is thus onerous for the smallest enterprises. Thus the EC has adopted a directive for micro-entities which enables member states to establish a simplified accounting regime and propose a revision of the accounting directives to (i) alleviate the accounting burden on small entities, and (ii) harmonize accounting requirements at EU level; such a harmonization would see companies bearing the same burden across the EU member states. In the Czech Republic, the requirement for preparing financial statements under the Act on Accounting applies to all types of companies as well as individuals who carry out business activities (i.e., "entrepreneurs") and are included in the Commercial Register. Small companies may prepare simpler financial statements when they are not audited; whereas, joint-stock companies must always draw up full financial statements, regardless of their size. Companies must also follow a mandatory chart of accounts, which prescribes the format and nomenclature of the accounting classes. The Czech Republic may consider:
- a) *modifying the thresholds for small entities* to exempt more companies from auditing requirements and allow them to prepare simpler financial statements; those companies could be subject to other assurance diligences, such as a limited review of financial statements. The Fourth Directive currently suggests higher thresholds for auditing than those currently prevailing in the Czech Republic;
 - b) *using* the option offered to EU member-states to introduce a simplified accounting regime for micro-entities. The Directive 2012/6 dated 14 March 2012 proposes a much simpler disclosure regime for entities which at balance sheet dates do not exceed the limits of two of the three following criteria (micro-entities): (a) balance sheet total: EUR 350 000; (b) net turnover: EUR 700 000; and (c) average number of employees during the financial year: 10.
- 101 **Filing of financial statements: Enhancing the filing ratios of financial statements at the Commercial Register by imposing progressive fines.** The First Company Law Directive requires that basic company documents, including financial statements be disclosed as a result of filing them with a company registry. In the Czech Republic, audited financial statements and the auditor's report must be submitted to the Commercial Register within 30 days of their approval by the General Assembly. When selecting reports for analysis in February 2012, the team noted that two out of three companies had not filed their 2010 financial statements. This finding is corroborated by a study, published by UOA in June 2012, which found that less than 30% of the companies actually filed their financial statements at the Commercial Register. The Ministry of Justice may consider enhancing its enforcement of the filing requirements by setting up an effective system that would impose well defined fines; fines would automatically increase for companies that continue not to comply with their filing obligations. This would create incentives for companies and their managers to file financial statements on time and arrange for their timely publication. Several EU member states, including Germany and Austria issue systematic fines to companies that

do not comply with their filing obligations, leading to improved filing ratios. The Ministry of Justice is responsible of this agenda and is already looking at possible remedies.

- 102 **Education and Training: Systematically including key findings stemming from the quality assurance reviews in the auditors' Continuing Professional Development Program.** This report identifies several improvements in KACR's certification program, including compliance with the requirements of the SAD and the IFAC's IES. In addition, KACR has increased the extent of equivalence between its own certification program with others offered by ACCA, which demonstrate further alignment with international practices. KACR members are also required to maintain their competence through participation in Continuing Professional Development Programs (CPD). The quality control review conducted by KACR Supervisory Committee found instances of poor compliance with ISAs in all areas of auditing, primarily among small practices. This calls for further training of auditors for them to improve their practices. The findings of the Supervisory Committee, including the primary instances of non-compliance with ISA, should be systematically fed into the annual CPD Program. The Committee could also encourage auditors whose performance has been found substandard to develop their skills through participation to specific training.
- 103 **Public Oversight and Quality Assurance: Strengthening the capacity of APOC to supervise the audit quality assurance system and making its reporting more effective.** APOC oversees auditing activities as well as those of KACR's activities specified in the Act on Auditing. Specifically as regards quality assurance, the APOC's role is to approve KACR's plan for quality control and supervise its execution. APOC may want to develop its capacity as the current arrangement depends on a few individuals and may therefore not be sustainable in the long run. In addition, potential changes to the SAD could require enhanced institutional arrangements to supervise the quality assurance system. This could include APOC taking a more direct role in reviewing the audit of public-interest entities. In, addition, APOC provides an annual report of all its activities that relates to the requirements of the Act on Auditing. That report enables the reader to understand how APOC complies with its legal mandate, and provides the details of APOC's meetings and operations. APOC may consider enhancing the quality of the annual report by clarifying the structure of the report and include an executive summary focusing on strategic issues, key results, and main challenges in faced in fulfilling its mandate. The executive summary could usefully include strategies to enhance audit quality and quality assurance activities, the results of which are described factually in the body of the report.
- 104 **CNB's Monitoring and Enforcement: Broadening the role of the CNB on enforcement of IFRS and the monitoring of the quality of financial statements.** CNB has initiated an annual review of 6-7 sets of financial statements prepared according to *endorsed* IFRS for companies that issue securities in a regulated market. This review complements the review of the prospectus and annual reports that the CNB undertakes for those companies. This very useful initiative should intensify and include more in-depth focus on specific topics following a risk-based approach. The CNB may also consider extending the scope of these reviews to banks and insurance companies that prepare financial statements under *endorsed* IFRS. To implement a risk base approach, the CNB may focus on the financial reporting topics published by the European Securities and Market Authority (ESMA) to assess the quality of listed companies' financial statements. Using those common enforcement priorities promote the consistent application of European securities and markets legislation and IFRS. For 2012,

the financial reporting topics refer to the application of IFRS in relation to: (i) financial assets; (ii) impairment of non-financial assets; (iii) defined benefit obligations; and (iv) provisions, contingent liabilities, and contingent assets.

105 **The above findings and policy options have been discussed with the Ministry of Finance, the CNB, KACR and APOC.** Instead of including prescriptive recommendations in the draft ROSC, the approach used in this case – which is preferred by the Czech government – is to propose policy options incorporating as many inputs as possible from the national authorities and the local private sector to provide a framework of identified issues. **Based on the above policies options, by the Czech authorities and in-country stakeholders may develop further reform.** Over time, the World Bank hopes to continuing informing the policy response of national authorities, and assist them in developing the resources to further their implementation of the EU *acquis* in order to enable them to advance Czech Republic accounting and auditing practices.

Implementation of the recommendations from the 2002 ROSC Accounting and Auditing

Action Plan According to the Resolution of the Government of the Czech Republic from 20 October 2004 as at 1 January 2011

| Recommendations | Category | Comments |
|---|------------------------|---|
| Definition of PIE to be enacted | PIE | Adopted in the Act on Auditing implementing the SAD |
| Submit amendments to the law in relation to PIE obligations. | PIE | Adopted in the Act on Auditing implementing the SAD |
| Role of Audit Committee of PIEs in appointing the statutory auditor to be enacted | PIE | Adopted in the Act on Auditing implementing the SAD |
| Legal requirement to apply IFRS to be enacted. | PIE | Adopted in the Act on Accounting implementing the requirements of the IAS regulation. |
| Audit oversight body to be enacted | Supervision | Adopted in the Act on Auditing implementing the SAD |
| Enact and implement a sanction system for failure by those charged with governance to prepare fair presentation financial statements. | Sanctions | Adopted in the Act on Accounting but not enforced. |
| Enact and implement a sanction system for failure by aligned with <i>the acquis</i> . | Sanctions | Adopted in the Act on Auditing implementing the SAD |
| Implement recommendations on internal rules and procedures of the Chamber of Auditors supervisory and disciplinary committee | Sanctions | Adopted in the Act on Auditing implementing the SAD. |
| Implement a system of for translating ISA into the Czech language by the Chamber of Auditors. | ISA | Implemented (2005) |
| Enact and implement financial statements publication requirements | Publication/ Filing | Financial statements of all limited liability companies are available |

| Recommendations | Category | Comments |
|---|--------------------|---|
| and the register. | | either on the PSE pages (www.pse.cz) or on www.justice.cz . The enforcement is poor with a very low compliance level at the Commercial Register |
| Implement a system for translating IFRS into the Czech language. | IAS | IFRS are published in the Official Bulletin of the EU in the Czech language; the translation is provided by the EC – DG Translation. |
| Enact and implement a system for enforcing IFRS | Revision of IAS | Act on Accounting includes sanctions regime but enforcement remains an issue. |
| Consider permitting accounting income determined by the application of IFRS to be the basis for taxation. | A&IT | Several studies performed but no changes. Tax base is determined on the basis of Czech GAAP accounting income. |
| Enact and implement categorization of companies (PIE, SME, micro) and consider appropriateness of the administration burden resulting from accounting requirements. | AoA and Czech GAAP | Adopted in the Act on Accounting implementing the Fourth Directive. Measures for Micro entities not adopted yet. |
| Submit to the government proposals for legal amendments based on the analysis of national GAAP by the ROSC team. | AoA and Czech GAAP | On-going - few recommendations were accepted due to EU directives requirements. <ul style="list-style-type: none"> - Changes in the strategy of accounting – done for financial institutions only. - Public Interest Entities: in accordance with the Seventh EU Directive these entities are included into the consolidated financial accounts. - Financial Leasing: treated as operational leases in Czech GAAP. - Substance over form: legalistic view prevails; however, true and fair override exists. - Subsidiaries: not anymore excluded from consolidation on the ground |

| Recommendations | Category | Comments |
|---|-------------|---|
| | | they would have a different kind of business activities |
| Consider creating a new body to be responsible for Czech GAAP. | Czech GAAP | National Accounting Council established by the accounting and auditing profession, the tax profession and academia, provides interpretations on accounting, which though not legally binding, aim to guide professionals in applying the relevant laws and accounting standards. NAC isn't responsible for issuing the Czech GAAP |
| Promote development of IFRS education as a part of university curriculum. | Education | University curriculum now includes IFRS |
| Enact CPD requirement for auditors. | Education | Adopted in the Act on Auditing implementing the SAD |
| Maintain and develop communication with EU bodies and para-governmental organizations involved in the development of accounting and auditing. | Cooperation | The Czech Republic participates in the discussions and the decisions made at EU level. It also cooperates with EFRAG and other organizations. The MoF consults with the Chamber of Auditors and the National Accounting Council at national level. |



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