

Auditing of SMEs: Issues Caused by International Harmonization of Financial Reporting (From Czech Perspective)

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Abstract—Small-and-Medium Sized Enterprises represent the most important group within national economies. Paper deals with the auditing issues in these companies from the Czech Republic firstly introducing the accounting and auditing legislature in the country. Starting with the general issues dealing with the requirements of SMEs' owners, paper discusses the measurement issues from the perspective of owner and manager. The crucial part of this paper is focused on the inaccuracies found during the auditing process in these companies.

Keywords—Auditing, SMEs, Czech Republic, measurement, financial statements, harmonization.

I. INTRODUCTION

IN the context of the international drive to simplify the "small-and-medium sized enterprises" (SMEs') financial reporting, one may identify a stringent call for the identification and serious analysis of the SMEs' specific users of information and their needs. Calling upon the literature that approached the influential factors of accounting systems, it submits a framework for analysis through which it may identify and determine the influence of environmental factors (cultural, institutional and accounting related) upon SMEs' financial reporting.

The literature we analyzed concerning stakeholders and their needs highlights the importance of identifying them in order to develop specific SMEs accounting regulations, but it does not determine their direct influence upon SMEs' financial reporting. There has to be mentioned the literature behind this research theme from the conceptual point of view, i.e. the

factors that influence different accounting systems, respectively theories/schemes for stakeholders' identification. In both cases, the literature is full of studies which are used within this research. Thus, the influential factors and the classification of accounting systems are approached by [8, 11, 13, 17, 18]. The general criteria for stakeholders identification, considered either from the manager's or from the stakeholders' point of view are approached [e.g. 4, 7, 10, 16].

The identification of SMEs specific stakeholders is rarely a subject in the literature. In the case of transitional economies is quoted by [6] and for the European context by [5, 19, 22]. The stakeholders' needs regarding SMEs' financial reporting are approached at the European level by [5]. Along with the academic literature there could be mentioned certain empirical studies undertaken by accounting regulation or consultancy organizations that outlined the most important stakeholders in SMEs, studies like: KfW Bankengruppe, Bundesverband der Deutschen Industrie e.V. and Ernst and Young. Other research projects or professional demarches on SME reporting are in progress, but not yet published.

The solutions for simplifying the SMEs' accounting are approached firstly by professional organizations. The most remarkable steps were taken by the IASB through its standard for SMEs, respectively the simplifications proposed by the European Commission. The literature did not develop concrete technical solutions regarding a standard for SMEs as it commented on these two actions taken by the professional/accounting regulating organizations. Thus, both in the stages of Discussion Paper and Exposure Draft, the IASB standard received much criticism and/or recommendations. One of the main observations was that the IASB did not really take into account the SMEs specific stakeholders and their needs. From this point of view there was also criticism brought to the European Commission's latest publications which address further simplifications of accounting rules and propose a differentiation of entities from an accounting point of view, according to sub-criteria regarding size and types of users. The importance of undertaking field studies in Europe is outlined as these studies would clarify the above aspects and their results would be taken into account in future SMEs accounting simplifications.

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II. MEASUREMENT ISSUES FROM THE OWNER'S AND MANAGER'S PERSPECTIVE

Valuation (measurement) in financial accounting is one of factors which determines the quality and reliability of presented information. Solution of measurement issues is one of the key problems analyzed within current basic research in financial theory. Applied principles of measurement and their regulations are interdependently correlated with the informational needs of external users (especially investors) and internal users (managers). Owners of the company may behave as external users (e.g. minority shareholders) or as internal users. Requirements on content of accounting information given by the used accounting (and measurement) method are strongly connected not only with the group of users (internal versus external) but also with economic environment. Actual economic environment strongly affects the requirements for measurement requested from users.

Upon economic boom there can be seen higher optimism of investors which leads towards requirement of measurement of all accounting items at fair values, which mainly represent current market prices of assets [1]. Using this concept means the turn from the prudence principle and conservative historical costs concept in financial accounting. Moreover fair value concept in financial accounting leads to higher tendency of revaluation assets or liabilities affecting profit or loss of the company.

Upon economic recession users reevaluate their views on accounting methods, especially the measurement bases. Economic recession evokes the renaissance of conservative approaches in measurement, especially the applicability of prudence principle. Confidence in financial market upon recession is thrilled; there can be seen strong price swings. Swings in market prices of financial instruments or breakdown of real estate market may also evoke valid doubts whether the fair value concept (and market price is the most reliable evidence) is really the most objective and most reliable approach suitable for wide spectrum of users of accounting information [3, 20]. When we try to find out the reasons of economic crisis, we can hear opinions that it was very optimistic information given by fair value accounting in the period of economic boom. But history used to repeat: the greatest moment was of course Black Friday at New York Stock Exchange, after which the crisis smite almost all world in 30s of 20th century. Also at that time there was often heard that accounting was unable to provide the information which may help users to predict this abrupt change [15]. The reaction on the mentioned crisis was the evolution of US GAAP – national standards which may be allowed to face the problems like this.

After the period of recession economy tends to break up strict conservative rules and principles because of the pressure of the investors' requirements; there can be seen divergence from the prudence principle towards measurement based on actual market prices (or so called fair values). This evolution was visibly seen during last decades, not only at international

level (standards IFRS and US GAAP) but also at national level (requirement to measure certain assets at fair value given by Czech Accounting Act). As a good example shall be stated the essential material of IASB (International Accounting Standards Board) prepared by group of Canadian experts which dealt with the measurement of assets and liabilities upon initial recognition and declared the divergence from historical costs measurement towards fair value concept. Quite important was also the common discussion paper of IASB and FASB (Financial Accounting Standards Board) which dealt with unification of fair value concept in IFRS and US GAAP [2]. We think that the tendency of fair value measurement results from the investors' pressure: the main objective for investors was capital spillover and maximization of short-term profit. It is impossible to ignore the fact that all these requirements were strongly connected with economic boom conditions.

Too "optimistic" approach applied upon economic boom is based on fair value approach [23]. The high value of assets which is given by active market or it is based on the estimates in case that active market does not exist, leads towards rising equity as well as balance sheet sum and in case of revaluation through profit or loss also towards fictive profits which can be distributed to owners. It shall be also stated that the estimates of fair values for non-financial assets, but also for certain financial assets (e.g. shares) used to have low level of reliability because of subjective estimates of valuator or based on mathematical models which are connected with restrictive assumptions.

On the other hand the approach based on accounting conservatism and prudence principle in recession periods may (jointly with inflation) lead towards erosion of company's substance and deepen and prolong the recession.

Financial reporting outputs are intended for presentation of the company to external environment, i.e. to external users, who determine the requirements for reporting outputs (i.e. financial statements and annual report). These requirements are (in certain level) mapped to system of normative regulation of accounting in countries, or in global (multinational) level. The influence of external users on content of accounting information is dominant during last decades and the role of owners and managers is conformed to investors' interest. In case those companies want to come across a market and receive necessary sources of capital for their businesses, they have to provide investors required information. In many countries (Czech Republic included) dominates strict accounting rules which provide to companies only very small manoeuvring space for presentation of information according to their specifics as well as investors' requirements.

Accounting data from financial accounting are intended not only for external users, but further to information from managerial accounting also for internal users and owners [12]. These requirements were much more respected during last phases of accounting evolution. It is essential that financial accounting shall rely on prudence principle and its connection

with the relevance of accounting information not only from the investors' point of view, but also from the view point of owners and managers.

Managerial accounting as a specific information system uses transfer prices just for the performance measurement and the motivation of responsibility centres, as well as an instrument of the delimited competence and responsibility for results of supplier and customer centres and also for allocation of costs and revenues among appropriate centres and on particular outputs.

The valuation of corporeal and incorporeal outputs from the managerial point of view takes on greater importance in consideration of the optimization of entrepreneurial processes and the perspective performance management of the company [9]. Companies with entrepreneurially oriented business and geographical action, of different law forms and with various business object are differed by various organizational and economic structure of centres, which "communicate" together, create outputs by requirements of external customers and give each other often services in dependence on the character and difficulty of the part of the entrepreneurial process, which secure; every responsibility centre should be managed with the aim of the achievement of the highest efficiency of their costs [21].

Transfer prices are considered as a traditional tool of the value management in this information subsystem and their application starts from long-term experiences and from practically verified theoretical basis. As they operate in the external unregulated information system, they must be determined by such way, which respects specifics of the company and its relevant needs in the area of the output, responsibility, process or customer oriented value management [14].

As for intradepartmental prices and their using as effective tool of the responsibility management, three assumptions should be fulfilled with their determination. Firstly, the intradepartmental price influences decisions of a centre, unless is assigned advance, eventually if rules for its assignment are determined advance. Therefore it is suitable as to be relatively invariable and as to be given conditions, when its changes can come. Secondly, intradepartmental price is the function instrument of the management, unless works with other instruments of the internal responsibility management, mainly with budgets of responsibility centres; the clear way of the assessment and the content of the intradepartmental price as the positive management tool are important for its assumption by supplier centre and customer centre. Thirdly, intradepartmental price of the homogeneous output should be assessed on the same level without relation to the fact, if other centres take the appropriate output or the output is sold to external customers.

Intradepartmental prices based first of all on costs (variable costs, full costs, full costs with the counting of the profit mark-up), intradepartmental prices based on the market price or assigned by the agreement among centres are used with the

valuation of internal outputs.

The main content difference between the intradepartmental price and market price follows from the various levels, when the purposefulness of the created output is recognized. The benefit on the border relation of the company and the market environment is expressed so, that the economically independent customer is willing to pay for a sold output the price answering by his opinion to usable parameters. On the other side the valued output of a centre shows only partial, from the company level the internal recognition of its purposefulness. Unless the output is given to the other consumption or evaluation inside the company, customer centre is restricted with the choice of the similar output from the external environment by the priority of interests of the company as a whole.

The significance and using of intradepartmental prices are fundamental for the company management. Upon period of the current financial crisis it is necessary to give the sufficient attention to its aspects in the sequence on existing system of intradepartmental prices (and its using for management purposes of companies), which will be modified in the certain measure just by results of possible financial crisis. Appropriate results will be shown both in transactions among supplier and customer centres inside the company and in valuation transactions of concern companies.

III. CURRENT BUSINESS ENVIRONMENT IN THE CZECH REPUBLIC

Business environment is relatively stabilized after 20 years of market economy in the Czech Republic and legislation governing it as well. But in Czech legislative rules are small and medium-sized business not limited, but they can be divided into groups, depending:

- if they are an independent accounting subject
- is so, what is the concept of their financial statement
- if their duty is to perform an audit

When a business becomes accounting entity, it is its duty to perform double-entry accounting. Accounting entity is business if:

- it is a corporate entity, that means a corporation according to Civil Code, regardless of legal form. Civil Code is specifying rules for capital investment (Joint Stock Company, Limited Liability Company) and for personal investment (public company, limited partnership company.) Such businesses are registered in a Business Registry.
- it is a personal entity, registered in Business Registry. Such a registration is mandatory and guided by a Civil Code if during two consecutive accounting periods business turnover is bigger than 120 mil.CZK (about 480 000 EUR) Such business can be registered voluntarily, but there is no advantage doing so, contrary, it is forcing business in such case to publish accounting results for example and other duties. During 90's, at the beginning of market economy there was an obligation to register if such a

business performed foreign trade, this was later canceled.

- if it is a personal entity with turnover during very last accounting period bigger than 25 mil.CZK (about 1 mil. EUR)
- if it is a personal entity deciding freely to register, regardless on turnover
- if it is a personal entity and shall became a member of association without legal entity but even just one member of such association is an accounting entity

Personal entities not belonging to either of above groups are keeping just tax files, showing their base for tax purposes. This is guided by income tax law.

Audit is obligatory in the Czech Republic for all companies exceeding the following limits:

- (i) assets (gross) higher than 40 million CZK (about 1.6 mil. EUR);
- (ii) net turnover higher than 80 mil. CZK (about 3.2 mil. EUR); and
- (iii) more than 50 employees during the period (in average).

For joint-stock businesses there is audit required in case of reaching or surpassing one of the limits specified above, for others two of the above limits. There is no limit if business is performing audit voluntarily.

IV. AUDITING PROFESSION IN THE CZECH REPUBLIC

Auditors are relatively young profession in Czech Republic. Even that during planed economy period there existed some form of financial statements auditing (accounting revision); they were without central rules and more of formal than content- oriented inspection. Real auditor profession was born in 90's and firstly mentioned were auditors by Czech legislature in law about businesses with foreign assets participation in 1989. Financial statements were for the first time audited by two independent auditors-experts, appointed by Ministry of Finance after their examination. This Ministry issued in the same year Bill of Auditors, where this profession was for the first time officially recognized. Professional organization – Auditors Union was established as well, transformed in 1992 into Chambers of Auditors Czech Republic according to the Auditing Act, passed the same year [24]. From then to 2009 such Act was many times updated according to the auditors' needs and EU harmonization processes.

In relation with Directive 2006/43/EC of the European Parliament about obligatory audit of final and consolidated financial statements new Act was passed in the Czech Republic (No.93/2009) where this Directive is implemented. Audit is therefore respected as an activity in public interest and as such a subject of strict regulation. In the Czech Republic as a first step in such regulation is professional self-regulation by Chamber of Auditors of Czech Republic and its bodies [24]. Second step is a control by an independent organization – Council for public supervision of audit, based on the same law. Council's duty is to increase credibility of auditors' profession

and accounting subjects audited, toward foreign and/or domestic investors, broad public and State institutions. Council is operated by Presidium having 5 members, who are selected and nominated by Minister of Finance in cooperation with the central bank (Czech National Bank). Presidium collaborates with following Committees:

- Committee for system quality observance and disciplinary measures;
- Committee for educational coordination and profession exams;
- Committee for audits cooperation and coordination; and
- Supervising committee.

Currently there are 350 audit companies and 1325 auditors (out of which 754 are audit companies employees) in the Czech Republic.

Small and medium-sized audit companies and individual auditors serving small and medium-sized businesses depend on each other. Small business where audit is necessary by law shall choose small audit firm or individual auditor unless, according to his foreign owner requirement is the same auditor selected as of parent business is using. Deciding factor is many times the price paid for audit, smaller by small audit companies than by large ones.

Basic question for audit-regulating bodies on domestic and international level is how different can be an audit for SMEs. The answer is always the same, audit is an audit and the rules shall be the same for everyone, data users shall, from closing accounts, be assured about their integrity. Deciding factor therefore is audit quality according to the international auditing standard ISQC1 – Auditing firms Quality management, Historical financial information verification, other verification contracts and related services [25]. It is obvious that one of the factors influencing this standard application is the accounting entity size, client and audit company as well. Standard is thus not observing some procedures irrelevant for individual auditors without employees, but audit services quality cannot be influenced than.

Czech Auditing Act is stating that auditor must use International Audit Standards (ISA) issued by IFAC (International Federation of Auditors); Czech version was issued by Chamber of Auditors Czech Republic. But even IFAC as an ISA issuer is conscious of limits by small audit companies or individual auditors serving SMEs, influenced by their administrative load and their application is many times formal. Use of some standards not for such auditors relevant and in a final part it is adding to the cost of audit. Committee for SMEs accounting and auditing profession issued guide for their quality management where instructions are included how to perform their services. Guide is designed for small audit companies with few employees and individual auditors without them.

Big audit companies are using their own quality control

guidance, formulated by inner or corporate regulations. Specifics are used mostly by small companies and individual auditors.

Following issues can be observed from this point of views:

- issue of observing Code of Ethics imposed on auditors;
- issue of observing quality requirements on audit performed

Chamber of Auditors is supplying any auditor with Czech version of IFAC Code of Ethics and they are committed to follow it. Basic ethical principles included in this Code of Ethics are:

- integrity and objectivity, professional performance, this has to be guaranteed by auditor
 - trustworthiness, his fidelity and honesty and conduct. Auditor can find themselves in situation where they are under constrain, influencing their objectivity. Forms of such constrain can be different, such as presents from clients, excessive hospitality etc. Those are a situation to avoid expert competence is necessary condition for quality of audit services. Entering this field, auditors are examined by Chamber of Auditors, verifying their professional quality. They are required to participate on 60 hours minimum of continuous professional education, supervised by Chamber.

Chamber of Auditors is screening:

- confidential information preserving, and secrecy, this is given by law. Secrecy exempt can be given by audited business itself or by Chamber. Law is specifying what it is not secrecy.
- All those requirements are relevant to an ethical demand of auditor independence. It can be endangered by many means, especially by those situations:
 - material interest, when a great financial gain is possible from services performed for client, It can be an investment participation on client business or distinctive size of fee paid for audit services. Or it can be a loan from a client and/or accepted guarantee, all this being a threat to objectivity
 - Self-auditing of own case is often endangering auditor independence with small and medium-size businesses. If the client accountant, completing the accounting statement is not qualified enough to arrange its parts, he might ask auditor for help, for example cash flow statement or supplement. There are cases of accounting statement being prepared by accountant. He is then auditing his own work.
 - Cases of protectionism are if auditor shall

become a broker for client stock or directly selling them. It is impossible as well if an auditor and simultaneously a lawyer is representing client in legal cause or litigating in dispute with third party.

- Kinship is another situation, where the client and auditor are relatives. It can be relation among owners or members of management which can influence audit outcome.
- Blackmail from client side is dangerous if client is threaten by using another auditor services if the audit results are negative. Accepting presents and excessive hospitality are committing auditor to influence audit size and results.

Second field emphasized recently in connection with Directive 2006/43/EC is audits quality control. System of quality control is governed by Chamber of Auditors, using its own body, Supervising Committee, as required by law. This Committee is closely cooperating with Council for public supervision of audit. In case of shortcomings in auditors service the case is presented to the Disciplinary Committee, issuing disciplinary measures according to the case importance (warning, fine or temporary/final suspension. Most often cases seen on such supervisory inspections are not keeping audit standards especially:

- working without or using just formal audit plan and not-following strategy according to ISA 300 (Planning an Audit of Financial Statements) in regards to the planning of the performed procedures and evidence;
- Insufficient evidence of auditor services, from auditor files is cannot be seen which procedures auditor did performed;
- Insufficient assessment of contract risks, it is not clear which risk factors were judged and if at all (ISQC 1 – Quality Controls for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements);
- Lack of importance level assessment and uncertainty how to work with this level during testing and sample selection (ISA 320 – Materiality in Planning and Performing an Audit);
- Insufficient review of accounting subject information system which shall care about information quality and complexity (ISA 500 – Audit Evidence; and ISA 530 – Audit Sampling);
- Risk of fraud is not assessed or lack of (or bypassing) of internal business control mechanism;
- Insufficient or missing evidence of closing accounts in relation to the accounting balance and/or evidence in closing accounts supplement and annual balance sheet (ISA 500).

V. MOST FREQUENT INACCURACIES DURING AUDITING OF SMEs

One of the major problems of Czech accounting is its close relation to taxation. Since the financial statements are used as a basic indication for income tax, many businesses tend to minimize this result and thus income tax base. Rarely there is the opposite situation – to maximize the tax base, this is the case when on business economical results are directly tied to the management bonuses [23]. This is but the trend within large corporations; SMEs with one or few owners are finding the ways how to extract profit by other means, mostly by using tax-deductible expenses. There are many other possibilities, some of them breaching the Income Tax Act; businesses are hoping that accounting inspection will not find them. Let's discuss some of them:

Long-term Assets

To classify an asset as long-term one is not respecting the assets life-time but tax limits according to the Czech Income Tax Act being 40,000 CZK (or 1,600 EUR) for tangibles and 60,000 CZK (2,400 EUR) for intangibles. Assets up to those limits, even if its lifespan is longer than one year are treated as a direct cost. Invoicing is often by more than one invoice so it seems as more different items.

Inventories

Evidence of inventories is many times formal, annual stock-taking is omitted and inventories discrepancies not curbed. Inventories are filed into accounting system even if they do not exist or cannot be used, without appraising their fair value and correcting entry. Large deficiency there exists within unfinished production, not entered into accounting mainly in services sector. Another inadequacy is not to include indirect cost into inventories, which were not utilized.

Accounts Payable

Accounts payable are not collected on time, nor the correcting entry used or just partially if its influence tax base. Confirming letters are not sent to request the confirmation of active debts. Accounting is many times using out-of date debts or debts by companies in bankruptcy proceedings.

Travel Expenses

This sector is one of the most used to draw untaxed cash from company, especially there, where the owner is an employee as well. As travel expenses are paid non-existent trips or fake ones, persons are this way financing by company's money their vacation or holidays. Business reports are not required and use of cash is inconclusively documented.

Other Private Expenses Entering Business Accounting

Partners in small businesses are many times using company's money as their own, not drawing the line between their and company's cash. As expenses are often entered small items or equipment serving personal needs instead.

Fictional Accrued Tax Provision

Most misused provision, lowering the tax base is a provision for repair of long-term assets. Such a provision is part of expenses influencing taxation and company is forming it without really thinking about repair works. In future it has to dissolve this provision and increase tax base, but this delays the tax payment.

Reducing Sales Record

Selling for cash is an occasion to reduce sales record and thus income level. Reason is again an effort to lower the tax base. This can be done for purpose by business owners or by employees, thus making money out of inventories, keeping cash for themselves.

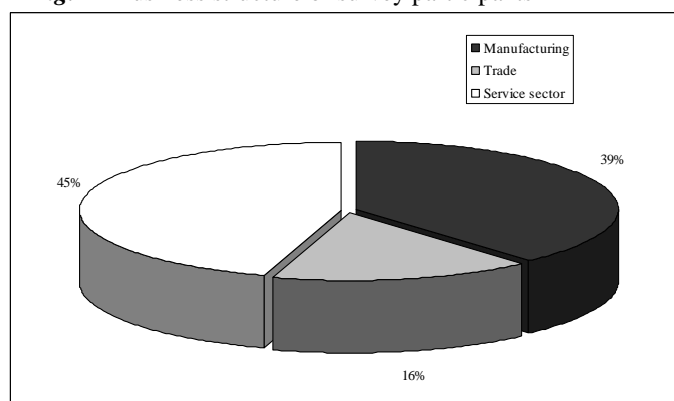
Fictional Invoices

Issuing the invoice for services never performed has double effect. Invoice is entered into receivables file and thus is lowering the tax base and more, accounting unit could claim VAT tax return. This way of avoiding taxation is but on verge of being illegal.

VI. RESEARCH FOCUSED ON CZECH SMEs' AUDITING

There has been performed a questionnaire survey dealing with the companies expectation from auditing of their financial statements. Research is summarizing the answers from 31 companies with less than 250 employees. Out of those, 12 companies are from manufacturing branch, 5 are trading businesses and 14 businesses are in service sector. Figure 1 is explaining this structure:

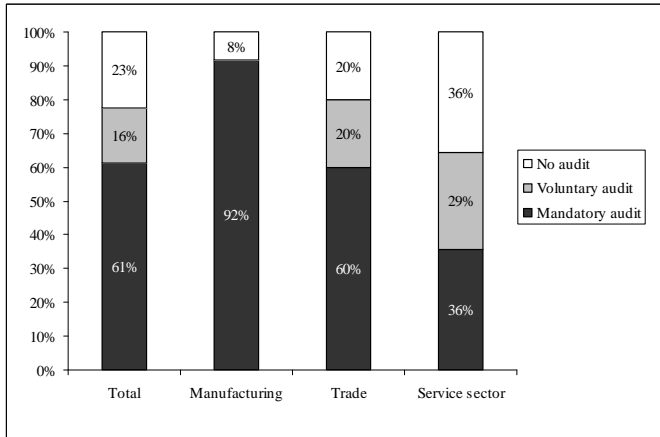
Fig. 1– Business structure of survey participants



Source: authors' research

Questions used in research survey were oriented on audit in SMEs. Main finding was their stance toward audit and their experience with it. Results are shown on Fig. 2:

Fig.2 – Business participation on audits

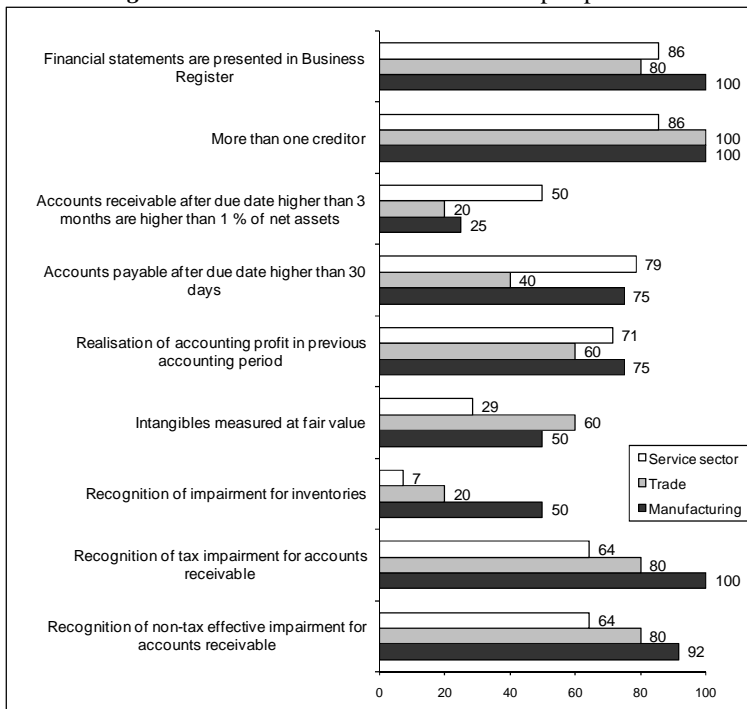


Source: authors' research

From this survey it can be seen that for more than 90% of manufacturing businesses is audit obligatory. Share of trading businesses is around 60% and service sector share is smallest with 36%. It is interesting to note that all businesses were participating on mandatory audit, for just one of the manufacturing businesses was audit not mandatory, it did not participated.

Further more research dealt with dummy questions focusing on problematic areas from the auditor's perspective. There could be seen that majority of companies are not willing to pay their accounts payable on time, however this is valid vice-versa.

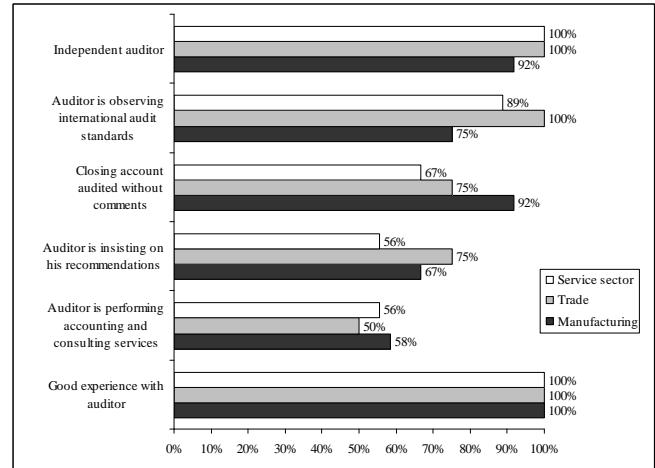
Fig. 3 – Problematic areas from auditor's perspective



Source: authors' research

Final part of survey dealt with companies experience with audit process; 25 companies did answered 6 questions regarding their experience with audit and its style and satisfaction with it. Results are presented on Figure 4.

Fig. 4 – Experience with audit



Source: authors' research

As it emerges from results there are not significant differences among different business sectors. It can be stated that:

- majority of auditors is working independently, that means they are not relatives and do not verify their own works;
- auditors are observing during their services international audit standards, since it is required by Auditing Act;
- most of the auditors' statements issued is without comments, that means that financial statements as issued by companies provide true-and-fair view on their real economy situation;
- not always auditor insists on its recommendations but if it shall influence his statement, he insists on them, since it could not issue a statement without comments;
- auditors can perform accounting and consulting services but not to the point where they later could verify their own work, auditor can advise during the accounting period and he can recommend for example accounting entry change but he cannot participate on financial statements preparation; and
- all participating companies were satisfied with auditors work.

VII. CONCLUSION

Audit in SMEs by small audit companies and individual auditors has its specifics; it is recognized by international and domestic audit regulators. On one side there is an effort to minimize administrative load, on the other side there is an effort to maximize audit quality.

Quality control is possible only by proper documentation, records on performed work. Updating Auditing Act valid since

2009 quality level requirement was increased. Demands on auditors working on SMEs financial statements are higher. Quality of their services and international standards observance is supervised by Chamber of Auditors. This is the reason for which our research of quality of SME auditors' performance shall continue in the future.

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