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POSSIBILITIES OF IDENTIFYING DISTORTION OF THE CALCULATION BASIS FOR THE PAYMENT OF DIVIDEND ON THE BASIS OF ACCOUNTING.

Hradecká, M.

Abstract

Financial earning from dividends and profit shares are important income for the owners. From the business corporation perspective is the setting of dividend policy important for keeping the financial stability and solvency of the corporation. The most important indicator of the financial performance of the corporation is the profit reached. Czech accounting rules allow to account some revenue and expenses of on the basis of estimates so that all expenses and revenue are accounted in the period which is related in matter and time. These items are often a means for creative distortion of the economic result with the aim to reach the required level of covenants that lead to payment of benefits, directors rewards and annuals rewards for the management and also for the overvaluing of the economic result as one of the variables for the calculation base for the payment of dividends. Current legislation for setting the calculation base for the payment of dividends is not satisfactory and does not protect against disproportional outflow of financial means in the form of dividends for the owners.

The paper concentrates on the possibility of identifying the distortion of the calculation base for the payment of dividends and on the proposal of a modification of the calculation base for the payment of dividends which would respect the legal right of the owners but also protect the financial stability of the business corporation and ensure its growth during its existence and to limit the outflow of money abroad.

Key words: calculation base for the payment of dividends, net profit, payment ratio, modified reporting, NTEDP (net total earning for dividend payments), tests of profitability and own capital, accounting.

JEL classification: G30, G32, M41, M42

1. Introduction

Dividend policy of a business corporation is important not only for the life cycle of the enterprise of the business corporation but primarily for the financial stability and solvency of the enterprise. Provided the management of the business corporation does not set detailed financial plans, does not conduct elaborate calculations of activities in respect to the cause – effect relationship nor does conduct appropriate dividend policy it can lead to enterprise's bankruptcy.

Current legislation that regulate the conduct of statutory bodies of business corporations and the accounting rules that set the way of creating the calculation base for payment of dividend and the disponible profit for their payment is insufficient and allow the outflow of financial means from the enterprise of the business corporation. This is spite of the fact that revenue and expences of parts of the projects which were not performed did not bring any cash flow to the enterprise nor any profits from the calculated activities. The article focuses on identifying the distortion of the calculation base for dividend payouts and modifying the established practices of the calculation base for dividend payout to owners based on accounting-based accounting practices.

The aim is to prepare a proposal for the formalization of the accounting methodology for determining the calculation base for the payment of dividends.

2. Dividend policy models

Dividend policy of business corporations is essential from the perspective of the life cycle of the enterprise. The appropriate setting of the payout ratio significantly influence the growth of the enterprise or decline which can even lead to bankruptcy.

Dividend policy is currently a discussed and sensitive issue in the Czech republic, particularly from the perspective of foreign investors who invested into Czech business corporations and their paid dividends transfer abroad.

These transfers influence the economy of Czech republic. French economist Thomas Piketty¹ (2018) dealt with this situation and conducted an analysis based on Eurostat data and other reliable sources. He arrived to the conclusion that western investors own a substantial part of the equity in Eastern Europe. Fixed equity represent about a quarter of this investment while acquisitions in corporations a bigger half.

Piketty warns of the income imbalance. According to him in the period between 2010 and 2016 by transferred dividends from Central European corporations represented according to Eurostat statistics 7,6 per cent of GDP (gross domestic product) and on the other hand the European subsidies was accepted 1,9 per cent of GDP. This means the amount of minus 1 689 billion CZK in seven years. For the Czech republic it is essential to create conditions which would make investors interested in re-investing part of the profits back inside the country. Economist Marek (2018) states that the worst alternative how to retain the profits in the Czech republic would be to create obstacles or prohibitions.

The Finance Ministry proposes restrictive measures since 2019 in tax deductible interest from the tax basis from loans between relatives. This proposed regulation in accordance with the EU ATAD directive (Anti Tax Avoidance Directive) of 2016 should prevent the outflow of financial means abroad. ²The restriction means that the interests from loans from business corporations and loans from banks provided they exceed 30 per cent of profit (EBITDA) before

¹ PIKETTY, T. (2018). ČEŠI JSOU PORAŽENÝM NÁRODEM. NA ČLENSTVÍ V EU PRODĚLALI NEJVÍC.

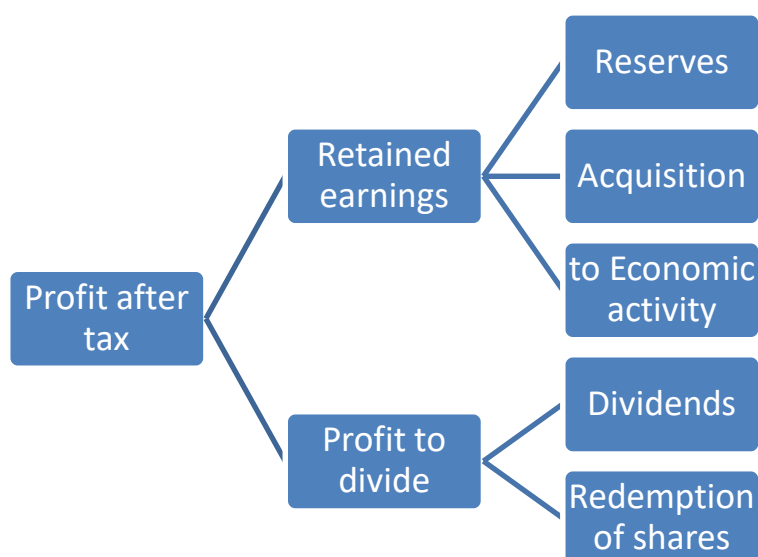
² MOUDRÝ, M. (2017) EVROPSKÁ SMĚRNICE OSEKÁ DAŇOVĚ UZNATELNÉ NÁKLADY, ČESKÉ FIRMY ZAPLATÍ STAMILIONY NAVÍC.

deductions of interests, taxes, depreciation and amortization shall not be tax deductible. However, the lower limit, where this regulation will not apply was set at 80 mil. CZK. The estimate of the increase of the tax revenue is 456 million CZK.

Comment: Also the Prime Minister of the Czech Republic Andrej Babiš³ aims at raising the dialog about the outflow of capital. In September 2018 he met the representatives of the major foreign corporations operating on the territory of the Czech Republic to increase the awareness of the importance of investment into projects involving infrastructure or support of culture and other spheres as opposed to the outflow of profits abroad.

Dividend policy of a business corporation sets the rules for the division of the profit (available cash flow without depreciation and amortization). What proportion pay off as dividend and what proportion retain for further reinvestment, so called payout ratio and activation ratio.

Fig. 1 Profit distribution of a business corporation



Source: Act: č. 90/2012 Sb. zákon o obchodních korporacích, Act: 89/2012 Sb. občanský zákoník, Author's processing

³ BABIŠ, A. (2018). NECHTE ZISKY V ČESKU, ŽÁDÁ BABIŠ INVESTORY.

Profit is the basic internal financial source. The amount for the payment of dividends must not exceed the amount of net economic result in the approval process in the terminated accounting period increased by the retained profit from the previous years and reduced by the losses of previous years. Provided the business corporation voluntarily creates funds from profit the resulting amount must be reduced by the transferred amounts into such funds from profit.

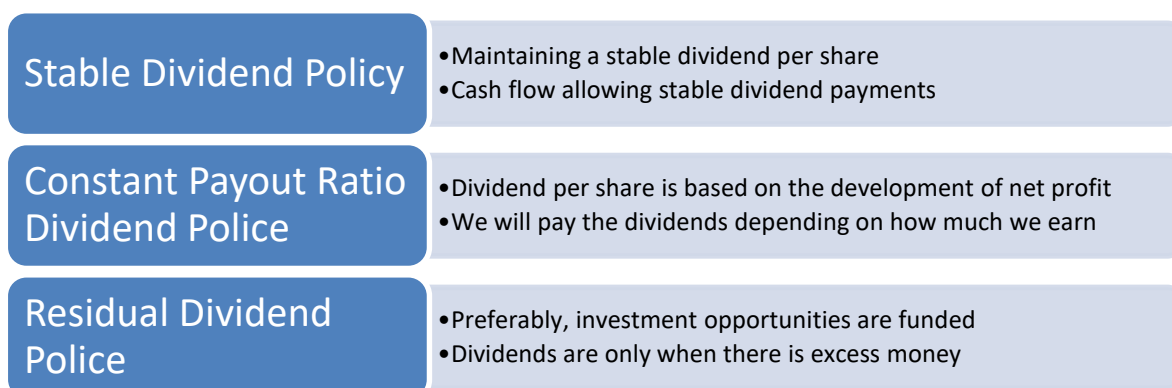
Regular financial statement are approved by the annual general meeting of the corporation at the balance sheet date. The payment of profit must be in accordance with the Act No. 90/2012 Coll. on business corporations in its valid wording particularly in the sense that the payment of dividend cannot lead to bankruptcy of the business corporation.

Table 1 Profit function

Function name	Description
Decision	Profit is a major factor in the decision-making process of the company
Accumulation	Profit is a function of capital accumulation for enterprise growth
Payment	Profit has a payout function (dividend payout, capital costs)
Motivational	Profit is the main motivating factor for enterprise growth

Source: Author's processing, Available from <https://www.oalib.cz>

Dividend policy represents a prediction of capital structure of the enterprise and the division of the economic result during the life cycle of the enterprise. There are various and numerous factor that influence the dividend policy. Particularly the legislation framework, the character of the economic activity, stability of the business corporation and also inflation.

Fig. 2 Major types of dividend policy

Source: Author's processing, According to Moyer and the team of authors (1990) and According to Marek and the team of authors (2009)

2.1 Stable dividend policy⁴⁵

Stable dividend policy is formed by stabilized legal customs according to which the long term strategies of the enterprise are approved.

- The value of the equity dividend for one common share/stock should be higher than the equity dividend for one common share/stock last year.
- Within the framework of its strategy the enterprise predicts the maximal amount of the dividend proportion which should not be exceeded.
- The increasing trend of dividend per stock is seen as a positive signal of the growth of the enterprise.
- The vertical rule of the superiority of legal custom applies

Equation 1 Test for a stable dividend value in a given year (Div)

$$\text{Div}_t = \frac{\text{EPS} \cdot \text{payout ratio}}{\text{the number of shares in circulation}}$$

EPS net earnings per share in the year t

⁴ MOYER, CH. R, MCGUIGAN, J.R., KRETLOW, W.J. (1990). CONTEMPORARY FINANCIAL MANAGEMENT

⁵ MAREK, P., A KOL. (2009). STUDIJNÍ PRŮVODCE FINANCEMI PODNIKU

Payout Ratio – the ratio of the distribution of profits to the payment of dividends and the retained earnings on reinvestment.

This test is conducted to compare the value of the dividend with the values in previous years. Provided the value of dividend shows an increasing or stagnating trend the dividend policy of the business corporation could be considered stable. However, if the business corporations adjust the payout ratio according to the cash flow rather than according to stable prediction of the payout ratio it can lead to higher caution of the investors. It is therefore necessary to predict the liquidity index especially the index of instant/quick liquidity. If there exists a demand for payment of higher dividend it is more suitable to pay out an extraordinary dividend which not volatile dividend policy of the business corporation.

2.2 Passive Residual Dividend Police⁶⁷

The passive residual dividend policy model consist in management of financial flows particularly internal flows. Investment opportunities and market factors influence the decision of the owners about the use of the available cash flow for further re-investment (postponed benefit). Provided there is not an appropriate opportunity on the market the available cash flow is paid out as the dividends.

Equation 2 Calculation of the postponed benefit for shareholders/stock owners

Calculation of the postponed benefit = Δ return from the reinvestment – Δ return from the payout dividend

Note: Δ – increase

Provided the result is positive it is a postponed benefit. In case of negative result it is a postponed disadvantage. The time value of money influences the evaluation of the investment opportunity and increase of the wealth of the shareholders/stock owners.

6 MOYER, CH. R, MCGUIGAN, J.R., KRETLOW, W.J. 1990. CONTEMPORARY FINANCIAL MANAGEMENT

7 MAREK, P., A KOL. 2009. STUDIJNÍ PRŮVODCE FINANCEMI PODNIKU

The following indexes are used for evaluation of the increase of value of the shares: ROE (Return on Equity), EPS (Earnings per Share), EVA (Economic Value Added), MVA (Market Value Added) or TSR (Total Shareholder Return).

2.3 Constant Payout Ratio Dividend Policy⁸⁹

The decisive element of this model is the initially set and fixed definition of the payout ratio. Business corporations specify increase or decrease of the dividend per share on the basis of the profit they reach.

Equations 3 Specifying the amount of dividend on the basis of the profit (D)

$$D_{t+1} = \frac{EPS_t * \text{Payout ratio}}{N(t+1)}$$

D_{t+1} dividend before tax paid out at the end of the period (t)

EPS_t net earnings per share of the corporation during the period (t)

Payout ratio – its planned height

N_{t+1} total number of all issued shares at the end of the period (t)

When comparing the individual models of the dividend policy we can say that the stable dividend policy is the most suitable model for big business corporation with large market share because they are able to fulfil the established customs of this model by their annual economic performance. On the contrary, smaller business corporations can consider the established custom an obstacle and that is why this model is not suitable for smaller corporations. The passive residual dividend policy model is too demanding for the management of business corporation as it makes complicated the long term planning of economic activity and requires

8 MOYER, CH. R, MCGUIGAN, J.R., KRETLOW, W.J. 1990. CONTEMPORARY FINANCIAL MANAGEMENT. USA. WEST PUBLISHING COMPANY. 1990. PP. 6 – 17. ISBN: 0-314-58059-X

9 MAREK, P., A KOL. 2009. STUDIJNÍ PRŮVODCE FINANCEMI PODNIKU. 2. VYDÁNÍ. PRAHA. EKOPRESS. 2009. PP. 459 – 496. ISBN: 978-80-86929-49-1.

time for repeated and frequent negotiations of the management with the owners about the suitability and effectiveness of the opened investment opportunity.

Decision of the annual general meeting of the owners of big business corporations about the amount of postponed benefit of investment can move away from the rentability and return on investment and cause the decrease of the value of the shares and earnings in a given accounting period. The passive residual dividend policy is suitable for small business corporations where the owners actively participate in the management of the corporation. Losses can similarly be caused by customs stemming from the model of constant payout ratio dividend policy. Even though the management of the business corporation can plan the re-investment better on the basis of available cash flow according to firmly set percentage of the profit achieved but with an important restriction in the form of the obligation to pay out part of the available cash flow in dividends. Provided there is an advantageous investment opportunity this obligation to pay out dividends may have a negative influence on the short term financial assets and therefore on the value of assets.

3. Literary overview (sources)

The issue of excessive outflow of dividends from business corporations and overestimation of the calculation base for dividend payout has become a concern in recent years and is the subject of a number of studies and articles mainly in countries with a functioning capital market. The topic of dividend policy was dealt with by Moyer¹⁰ and the team of authors (1998). They focused on the primary target of investors namely on maximalizing shareholders wealth. The secondary objective was to choose a method of dividend policy that would enhance the market share price. Other authors who deal with this subject are Marek¹¹ and a team of authors (2009) who deal with the different types of dividends and the forms in which they are paid. Block¹² and Hirt (1989) dealt with the topic of how best to make use of money generated by net profit, as well as a rate of return to society as compared to dividends. Brigham¹³ and a team of authors (1986) dealt with the hypotheses of factors that influence the market value of the dividend and the capital gain, especially the tax effects.

10 MOYER, CH. R., MCGUIGAN, J.R., KRETLOW, W.J. 1990. CONTEMPORARY FINANCIAL MANAGEMENT. USA. WEST PUBLISHING COMPANY.

11 MAREK, P., A KOL. 2009. STUDIJNÍ PRŮVODCE FINANCEMI PODNIKU.

12 BLOK, S. B., HIRT, A. G. 1988. FOUNDATIONS OF FINANCIAL MANAGEMENT

13 BRIGHAM, E. F., KAHL, A. L., RENTZ, W. F. 1986. CANAFIAN FINANCIAL MANAGEMENT.

Danos¹⁴ and a team of authors (1991) specialized in the analysis of dividend distribution by the rate method. Kislíngerová¹⁵ and colleagues (2010) focused on the costs of the invested capital. All of these authors have dealt with the dividend policy after the financial statements. This means at a time when the current period's accounts are closed and the net profit is already transferred to retained earnings. The choice of methods of dividend policy is a subsequent issue.

It may be distorted by creative accounting with attention to overstate equity for the distribution of dividends. Another author dealing with the dividend policy is diploma candidate Nevošádová¹⁶ (2013), who in her diploma thesis evaluated the impact of dividend policy on the market value of selected corporations and proposed the most optimal method for achieving the best results. Similarly, diploma candidate Kačerová¹⁷ (2011) has chosen for her contribution the topic of the question related to the dividend policy arising from the recent jurisprudence of the domestic courts. The issue relates to the right to share in profit, according to the now invalid Act No. 513/91 Coll. the Commercial Code, as well as the performance of profitability according to equity and insolvency tests. An analysis of the current state of dividend policy in the environment of Czech companies was made by Královič¹⁸, Lojda and Lojda (2009). The topic of their contribution was to introduce dividend policy as a significant area of financial management of joint-stock companies. The authors asked how the dividend policy affects the market value of the company. One research point is that an increase in dividends leads to a reduction in the value of the company. The second issue is that the company's value is independent of dividend policy (dividend neutrality). The authors came to the conclusion that the value of the company is influenced by the worsening economic situation, the restructuring of the economy and the fact that the capital market responds very sensitively to changes in society rather than the chosen dividend policy methodology.

Another author who deals with the dividend policy is Masry¹⁹ (2018). In his contribution, the author analyzes issues of dividend policy in the environment of banks in Egypt. Masry states that taxes, transaction costs and information asymmetries are important issues affecting

14 DANOS, P., EUGENE, A., IMHOFF, JR. 1991. FINANCIAL ACCOUNTING

15 KISLINGEROVÁ, E., A KOL. 2010. MANAŽERSKÉ FINANCE

16 NEVOŠÁDOVÁ, D. 2013. DIVIDENDOVÁ POLITIKA PODNIKŮ V ČR. DIPLOMOVÁ PRÁCE.

17 KAČEROVÁ, L. 2011. AKTUÁLNÍ OTÁZKY DIVIDENDOVÉ POLITIKY. SVOČ

18 KRÁLOVIČ, J. LOJDA, J. 2009. ANALÝZA SOUČASNÉHO STAVU DIVIDENDOVÉ POLITIKY VE VYBRANÝCH A.S. V ČR, MEZINÁRODNÍ KONFERENCE OSTRAVA

19 MASRY, M. 2018. FAKTORY OVLIVŇUJÍCÍ DIVIDENDOVOU POLITIKU NA VZNIKAJÍCÍM KAPITÁLU

dividend policy. The advantages and disadvantages of reinvestment were examined by Marek²⁰ (2008). The author analyzed the methodological problems associated with the construction of the model of the deferred benefit, respectively the disadvantages of reinvestment. This model is called the passive residual policy model.

The principle of the method is that dividends are paid only if they are more profitable than investment opportunities. In model computations, the author works with the indicator of profitability and the law decreasing yields from the scale. This means that with each unit of capital expended, a lower level of profit will be achieved. Marek²¹ (2007) analyzed the thesis of Miller and Modigliani (1961) on the new direction of dividend policy, namely dividend neutrality. Critics of this neutrality state that this new direction is unusable in the financial world. They presented counter-arguments, such as differences in the taxation of dividends and capital income, information asymmetry, representation expenses, flotation costs that reflect administrative costs and the risk associated with raising capital on the basis of securities issues. Finally, Marek notes that the thesis of dividend neutrality is still incomplete, but is, in his opinion, valid. Research on the issues of the existence of a positive relationship between the size of the dividend and the value of the company was carried out in his bachelor thesis Strnad²² (2013). He analyzed the signals that dividends convey information about the company's condition from managers to investors. Strnad notes that dividend policy is one of the main areas that have not yet been satisfactorily resolved. Ahmed²³.

Pacheco and Carolos (2007) dealt with financial and behavioral factors affecting dividend payout decisions. In particular, they focused on how investors evaluate the cash dividend compared to capital gains. Similarly, the second group of authors dealing with dividend policy does not deal with accounting aspects that can significantly distort the calculation basis for dividend payments, ie in the period before the financial statements. Similarly, the second group of authors dealing with the dividend policy does not deal with accounting aspects that may significantly distort the calculation basis for dividend distribution, ie before the financial

20 MAREK, P. 2008. MODEL ODLOŽENÉ VÝHODY, RESPEKTIVE NEVÝHODY Z REINVESTOVÁNÍ – METODICKÉ PROBLÉMY.

21 MAREK, P. 2007. VĚČNĚ ŽIVÁ DIVIDENDOVÁ HÁDANKA.

22 STRNAD, J. 2013. SIGNÁLNÍ EFEKTY DIVIDEND. BAKALÁŘSKÁ PRÁCE

23 AHMAD, H. J., PACHECO, O., CAROLOS, J. 2007. THE ECONOMICAL AND BEHAVIORAL DETERMINANTS OF CASH DIVIDENDS POLICY.

statements. The authors Ištvánfyová²⁴ and Pelák (2010) investigated the impact of changes in accounting standards on the behavior of entities that are required to report information from the financial statements. They analyzed the definition of available resources according to the now invalid Act No. 513/91 Coll. the Commercial Code and accounting regulations. Accounting policies allow revaluation of assets and liabilities in justified cases in order to increase the reliability of reported information. For example, for long-term financial assets. This revaluation²⁵ is reflected in unrealized gains and losses in the economic result or equity. The balance sheet revaluation of assets predominantly increases equity, the company so richly. The authors of the article thus compared the provisions of the Commercial Code regarding the protection of the creditor, whether it was possible to pay dividends from such unrealized profit.

The authors conclude that such unrealized revenue should not be paid but this argument can be contradicted by the fact that the Commercial Code does not distinguish realized and unrealized revenue. Debate on this subject they are considered to be philosophical rather than legal or accounting. The subject of the article already includes accounting aspects, but only the range of unrealized revenue and expenses from the revaluation of assets that affect the value of equity. Accounting rules compare with the now-invalid Commercial Code. Currently is the valid Business Corporations Act (Act No 90/2012), about companies and cooperatives, which contains a completely new arrangement, as I analyze in my article in the next chapters. Similarly, Chen²⁶ and Gavius (2015) out of the University of Israel dealt with the issue of dividend payouts from unrealized gains. The issues were analyzed from the point of view of the national GAAP and from the point of view of the subsequently adopted international accounting standards IFRS. The authors conducted research at 508 companies transformed from GAAP to IFRS in 2007. They have been collecting data from these companies' reporting over the last 6 years. The survey found that 33 % of companies paid dividends from unrealized gains. They have expanded their research into a research question, whether the aggressive payout policy is linked to the aggressive behavior of corporate management. Both financial and tax strategies and procedures have been analyzed. The findings of the survey have shown that

24 IŠTVÁNFYOVÁ, J. PELÁK, J. 2010. VLIV ÚČETNÍCH NOREM NA KONCEPT DIVIDENDOVÉ POLITIKY V ČESKÉ REPUBLICE.

²⁵ § 8 a §51, Degree 500/2002 Sb. Degree n. 500/2002, Sb., prováděcí vyhláška k účetnictví, (Act No. 563/1991)

26 CHEN, E. AND GAVIOUS, I. 2015. UNREALIZED EARNING DIVIDENDS AND REPORTING AGGREASIVENESS.

companies that have paid dividends from unrealized gains are in the gray zone of laws. That is, they used gaps and discrepancies between accounting and tax regulations to manipulate bookkeeping and tax revenue. At present, this manipulation is no longer possible because, under international standards, unrealized gains and losses are showed outside the ordinary profit and loss, in the statement of comprehensive income.

The description of earning management as referred to in English as the overestimation of economic outcomes has been discussed by Bergstresser a Philippon (2006).²⁷ In this article authors describe, that Xerox business corporation managers manipulation of revenue. US Securities and Exchange Commission have initiated legal proceedings against Xerox for fraudulent overstatement of sales. Behavioral features influencing management behavior in discretionary revenue management are examined in the article by Habib²⁸ (2012). Team of authors Lin²⁹, Chen, a Tsai (2017) examined the relationship between information asymmetry, dividend policy, and ownership structure in companies whose share are quoted on a stock exchange. In its conclusion stated that higher asymmetry in information occurs in corporations that pay less dividends. Marai a Pavlovic³⁰ (2013) explores accounting fraud in reporting and categorize fraud levels from US GAAP³¹. Author Drábková³² (2011) deals in her doctoral thesis with with creative reporting and the possibilities of identifying financial statement distortion.

The methods for detecting accounting fraud, such as the, such accrual principle quality model or balance model DMCFA, applied to the data of selected business corporations as well Kouřilová³³ et alii. (2016) in her scientific monograph. Hantková³⁴ (2015) in her graduate thesis studied forensic accounting. She focused mainly on ethics in accounting and fraud categories

27 BERGSTRESSER, D., PHILIPPON, T. (2006). CEO INCENTIVES AND EARNING MANAGEMENT. JOURNALS OF FINANCIAL ECONOMICS.

28 HABIB, J. (2012). EARNING MANAGEMENT AND BOARD OVERSIGHT AN INTERNATIONAL COMPARISON.

29 LIN, T., CHEN, Y., TSAI, H. 2017. THE RELATIONSHIP AMONG INFORMATIK ASYMMETRY DIVIDEND POLICE AND OWNRSHIP STRUCTURE

30 MARAI, A., PAVLOVIC. V. (2013) EARNING MANAGEMENT VS FINANCIAL REPORTING FRAUD KEY FEATURES FOR DISTINGUISHING. FACTA UNIVERSITATIS. ECONOMICS AND ORGANIZATION

31 US GAAP – AMERICKÉ ÚČETNÍ STANDARDY, GENERALLY ACCEPTED ACCOUNTING PRINCIPLES PRO AMERICKÉ SPOLEČNOSTI

32 DRÁBKOVÁ, Z. (2011). KREATIVNÍ ÚČETNICTVÍ A ÚČETNÍ PODVODY JAKO PORUŠOVÁNÍ VĚRNÉHO A POCTIVÉHO OBRAZU ÚČETNICTVÍ. DISERTAČNÍ PRÁCE JČU, ČESKÉ BUDĚJOVICE

33 KOUŘILOVÁ A KOL., (2016). METODY: AHP, CFEBT, DMFCA JAKO MOŽNÁ IDENTIFIKACE CHYB A PODVODŮ V ÚČETNICTVÍ. JČU, ČESKÉ BUDĚJOVICE

34 HANTKOVÁ, Z. (2015). FORENZNÍ ÚČETNICTVÍ A HOSPODÁŘSKÁ KRIMINALITA. DIPLOMOVÁ PRÁCE, JČU V ČESKÝCH BUDĚJOVICÍCH

and audit procedures for fraud detection. Team of authors He³⁵, Ng, Zaiats a Zhang (2017) have been researching the link between dividend policy and revenue management across countries based on statistics from 29 countries worldwide. They agree that greater revenue management creativity occurs in countries with less investor protection and weak institutions. Authors Mulford³⁶ a Comiskey in their scientific work, dealt with the amendment of US accounting standards in relation to the detection of fictitious revenue and misrepresentation of the financial statements. In their work they develop possibilities of uncovering creativity in accounting and statistical verification of valuation methods. Other authors are Marinela³⁷ and Corina. (2012), whose intention was to innovate accounting regulations according to international accounting standards for reasons of accounting creativity.

All the contributions of these authors in this chapter are focused on disponible profit and dividend policy methods and earning management without linking to accounting and Czech accounting regulations, possible manipulation of accounting books, and thus distortion of economic result. An important consideration is to prevent accounting manipulation in order to overestimate the net profit to increase disponible profit for the distribution of dividends. The solution that can be offered is on the very basics of accounting and legislation that define the disponible profit and regulate the legal conditions for the payment of dividends. The aim of this article is to highlight the issue of dividend policy on an accounting basis czech regulations, that is, at the stage of determining the calculation basis for the payment of dividends that results from accounting. Another objective is the proposal (modification) of calculation basis for the payment of dividends that are different from the accounting profit or loss (net profit) to prevent distorted for the net profit for overstatement of disponible profit, and the proposal to modify the financial statements to clarify the statements of the causal link between the expenses and the presented revenue. To achieve the goal, methods of analysis, comparison, deduction, prediction, modification, amendment were chosen.

4. Methodology

Based on an analysis of the current dividend policy, other procedures were chosen. 1. Review of the current state of the procedure for the calculation basis for the payment of dividends and the established customs for the payment of dividend. 2. Proposal to modify the determination

35 HE, W., NG, L., ZAIATS, N., ZHANG, B. 2017. DIVIDEND POLICE AND EARNINGS MANAGEMENT ACROSS CONTRIES

36 MULFORD, W. CH., COMISKEY, E.E. (2002). THE FINANCIAL NUMBERS GAME.

37 MARINELA, Z., CORINA, I. 2012. EMBELLISHMENT OF FINANCIAL STATEMENTS THROUGH CREATIVE ACCOUNTING POLICIES END OPTIONS.

of the calculation basis for the payment of dividends. 3. Application of the proposed procedure for determining a modified calculation basis for the payment of dividends on the reporting data of a selected real business corporation. 4. Comparison of the results of the data according to the current situation and the proposed modified procedure. 5. Proposals for amendments to legal and accounting regulations. 6. Discussion. 7. Conclusions.

4.1. Procedure for setting the calculation base for the payment of dividends

Current situation of established custom for payment of dividends. The first established custom is the height of the economic result after tax (EAT Earnings after Tax) in the current accounting period (year). The second established custom is the value of the disponible undistributed profit from previous years and the third established custom is the value (quality) of the business corporation. The payment of dividends must not lead to the bankruptcy of the business corporation. The quality of a business corporation can be found using various solvency and bankruptcy models, for example Kralicek Quick test, Index IN, Altman Z Score formula, Aspect Global Rating, and so on. Accounting result of the economic activity in a standart accounting period is currently formed by all revenue and expences of operating and financial activity in the statement according to types without reflecting cause-effect relationship particularly in the area of expences referred to individual activities of the business corporation (accounting unit) and without reflection of the value-creating activities. The disponible undistributed profit is under current situation formed by net earnings after taxes (EAT) in the approval procedure for the terminated accounting period, increased by undistributed profit of previous years and lowered by losses in the previous years or decreased by voluntarily created funds from profit.

4.2. Current procedure for establishing the calculation basis for the payment of dividends.

The first step should be the detection the solvency of the business corporation using the solvency and bancruptcy models. Using these models should inform the accounting unit (corporation) whether the payment of dividend does not represent a potential threat of bankruptcy. Provided the business corporation is not situated in the grey zone or the zone that

signalize bankruptcy on the basis of the results of these models, it can proceed to the next step of the detection. The second step is the detection of reached economic net result of the corporation. Earnings after taxes (EAT) can be a positive value number, which means the company reached a profit or it can be a negative value number which means the accounting loss was reached. Provided the earnings after taxes is a positive the corporation can proceed to the next step of the detection. The third step is the detection of the value of the disposable undistributed profit of the previous years. Provided the business corporation has unpaid losses from previous years that exceed disposable profit of previous years the management of the business corporation have to propose to the general annual meeting of the owners the payment of the losses from the previous years. Only after that, provided there is still some net profit left can the corporation propose the distribution of this profit between reinvestment and payment of dividends by the approved dividend policy.

The structure and distribution of individual items of the final accounts and the profit and loss account have direct influence on the calculation basis for the payment of dividends. Accounting and reporting founded on the reporting revenue (income) and expences according kind, distorts significantly the calculation basis for the payment of dividends. The calculation basis can be overvalued or undervalued by this structure in some accounting periods. Provided, the accounting would be based on calculations of value-creating activities it would give a more truthful picture of the economic result of the main economic activity separatedly from the other operational activities. Value-creating activities particularly include calculated cause-related personnel expenses (wages and insurance), depreciacion and amortization of assets, that are used in the given project or order, calculated participation on rent and related services, calculated part of the overheads, part in the costs of capital, cause related part in advertising and transfer pricing of controlled transactions of the concern and so on. Other income and expences that are not cause-related with value-creating activities would be reported in the operating economic result under gross profit or loss from the main activity. The profit and loss account constructed on the basis of value-creating activities would provide for better detection of accounting fraud, frauds in the area transfer pricing of controlled transfer transactions and higher transparency and objectibility for potential investors.

Table 2 Comparison the structure and composition of the individual items of the profit and loss statement

Statement according to types of expences	Modified statement
Service revenue	Service revenue
Performances consumption (Value added)	Value-creating activities Gross profit or loss
Payroll	Other Payroll
Value adjustments (depreciation, Adjustments)	Other value adjustments
Other operating income	Other operating income
Other operating expences	Other operating expences
Operating profit or loss	Operating profit or loss

Source: Decree No. 500/2002 Sb., which regulates the content of the financial statements, Author's processing

Table 2 clearly shows the separation of the gross profit from the main economic activity from the other operational activities in the modified statement. The statement composed on the basis statement according to types expences shows largely distorted added value and similarly distorted added value adjusted by payroll expences and depreciacion of fixed assets because the items of operating consumption, payroll expences and accounting depreciacion include all expences without distinction to causal link.

4.3. Procedure for setting the modified calculation basis for the pament of dividends.

Modification of the calculation basis for the payment of dividends is closely related to the proposed changes in the area of accounting rules. Namely it refers to the change of the structure and composition of the profit and loss statement in the modified format of value-creating activities and the addition of items in the descriptive attachment of financial statement regulated

by the Decree 500/2002 Coll., in its valid form for enterprising subjects that specifies some provisions of the Accounting Act 563/1991 Coll., in its valid form. The items proposed addition are particularly: distribution and purpose of the received services. Costs of outside capital into this services and costs of outside capital, which are included according to casual link to the calculation of price of services or goods which create the added value (adjusted added value) and on services and costs of outside capital other operational character. Further changes on Czech accountancy standarts regulating the valuation.

For example, introduction of the obligation of calculation of all corporate activities. The proposed modification of established customs for the payment of dividends primarily stems from modified net economic result (total earnings) for dividend payment (NTEDP). Further, from the quality of undistributed profit from previous years adjusted by selected liabilities and also from the established customs, quality of the business corporation from the modified profit and loss statement. Modified economic result after taxes is profit after taxes (EAT) adjusted by the earning from the main economic activity which were not realized, than operational income from sale of fixed assets and materials and also by items of earnings from received subsidies and insurance compensations. On the expences side these include adjustment not realized expences from the main economic activity and other operational expences from sold fixed assets on the residual value and material. The items of not realized³⁸ revenue and expences from the main economic activity refer to values accounted on correlative accounts of estimamated income or estimade losses (recommended account classification 388 a 389) and also to the values of unrealized revenue and expenses accounted on correlative accounts of un-earned revenue and pre-paid expenses (recommended account classification 385 a 381), provided they are not realized³⁹ to the time of the general annual meeting which approves the financial statement for the given period and which decides about the distribution of net profits. The reason for not including these entries into the calculation basis are numerous.

³⁸ THESE ITEMS OF UNREALIZED INCOME AND EXPENSE FROM THE MAIN ECONOMIC ACTIVITY ARE CONSIDERED TO BE REALIZED UNDER THE CURRENT REGULATIONS, BUT MAY BE DELIBERATELY OVERSTATED TO SECURE THE REQUIRED AMOUNT OF COVENANT FOR THE PAYMENT OF TANTIEMS BONUSES AND DIVIDENDS OR PROFIT SHARES. THE OPPORTUNITY TO MANIPULATE, IN PARTICULAR, THE REVENUES CHARGED THROUGH ACCRUALS ACTIVEIS DUE PARTLY TO THE FACT THAT THE REPORTED REALIZED INCOME, WHICH IS ALSO INCOME IN THE ACCOUNTING PERIOD, ALSO GENERATES A CASH FLOW THAT IS EASILY MEASURABLE. WHILE ESTIMATED REVENUE ACCRUED TO THE PERIOD TO WHICH THEY RELATE, BUT THEIR INCOME IS RECOGNIZED IN CASH FLOWS ONLY IN THE FOLLOWING ACCOUNTING PERIOD, IT IS NOT POSSIBLE TO MEASURE IT WITH A FIXED CHANGE.

³⁹ THAT IS, IF IT CREATES A CASH FLOW UNTIL THE GENERAL MEETING TO ENSURE THE SOLVENCY AND LIQUIDITY OF THE CORPORATION AFTER THE DIVIDEND IS PAID OUT, AFTER THE CASH OUTFLOW

Primarily items of unrealized income and expenses from the main economic activity these entries are often means for creative distortion of the target final economic result with the purpose of reaching the required height of the covenant for granting benefits, directors fees and annual rewards for the management and also for the overestimating of the net profit of the corporation as the calculation basis for providing the payout of the dividend. In the following accounting period the management of the business corporation has to solve the dissolution of a part of the created unrealized revenue⁴⁰ into other net income or other net losses of economic activity in previous years⁴¹ (account 426 of the recommended account classification) as a consequence of overestimated unrealized revenue, particularly estimated items and therefore overestimated economic result. At the same time it is necessary to modify the tax obligations⁴² towards the state. All accounts will be balanced from the accounting perspective however, from the perspective of cash flow, liquidity, stability and the composition of share holders' capital (equity) of the business corporation it is otherwise. Adjustments of the economic result decrease the size of the equity particularly because they revise the economic result of previous year. By paying out the dividend (profit share) the undistributed profit of previous years is lowered and the outflow of money occurs. It is necessary to recalculate the test of equity after the balancing day of accounting statement in accordance with § 350, parts 1 and 2 of the Corporation⁴³ Act.

„A company may not distribute profit or other own resources among its shareholders if, as at the last date of the accounting period just ended, its equity as shown at the regular or extraordinary financial statements or its equity after such profit distribution will fall below the amount of the subscribed registered capital increased with the funds which cannot be distributed among the shareholders pursuant to this Act or the articles of association“.

40 DIFFERENCES IN THESE DELIBERATELY OVERSTATED COST AND INCOME ITEMS CAN BE CHARACTERIZED AS ERRORS, OR DELIBERATE ERRORS, AND CAN BE CATEGORIZED AS UNREALIZED REVENUES AND EXPENSES. MANAGEMENT THAT DELIBERATELY COMMITS THIS MANIPULATION OF REVENUES AND EXPENSES IN A SINGLE FINANCIAL YEAR WILL DISSOLVE THOSE DIFFERENCES AS A DEVIATION OF ESTIMATES IN THE FOLLOWING YEAR'S FINANCIAL RESULTS, THEREBY DISTORTING THE SUBSEQUENT FINANCIAL YEAR. THIS PROCEDURE IS IN CONFLICT WITH CZECH ACCOUNTING RULES. DEFINED DIFFERENCES AS ACCOUNTING ERRORS ARE CORRECTED IN THE SUBSEQUENT PERIOD SOLELY ON THE BALANCE SHEET INTO EQUITY.

41 §15A, DEGREE N. 500/2002, SB., PROVÁDĚCÍ VYHLÁŠKA K ÚČETNICTVÍ, (ACT NO. 563/1991)

42 §23, ODST. 3, ACT N. 586/1992 SB. O DANÍCH Z PŘÍJMŮ, V PLATNÉM ZNĚNÍ

43 ACT. N. 90/2012 SB., ZÁKON O OBCHODNÍCH SPOLEČNOSTECH A DRUŽSTVECH, V PLATNÉM ZNĚNÍ

Provided the payment of dividends led to breaking of the test it means that the business corporation paid the dividends unlawfully and contrary to the Corporation Act. Secondly, these entries of unrealized revenue and expenses did not contribute through the cash flow to the real value of the liquidity and solvency index which is an essential parameter for the payment of dividends. Entries of operational income and expenses from sales of fixed assets and material (accounts of the recommended account classification 541 a 641) should not enter into the modified economic result for the payment of dividends, because they did not arise from the main economic activity (value-creating activities) of the accounting period and the cash flows from sales of fixed assets and material should be directly re-invested into new fixed assets without considering the size payout ratio and the dividend policy. The last group are the entries of operational income from the title of subsidies and compensations from insurance company. The subsidies from state budget provided to the corporation (accounting unit) are aimed as supportive monetary means to cover the expenses of the corporation, for example by employing handicapped staff or for agricultural activity. It is therefore not acceptable to include them into the calculation basis for the payment of dividends as the objective of the subsidies provider is not to increase the wealth of the owners but support of employment or other subsidized activity. Similarly the compensations from the insurance company should be directly used to cover the losses caused by the insured accident and for reinvestment into fixed assets without consideration the planned size of the payout ratio and dividend policy.

4.4. The proposed procedure for setting the modified calculation basis for the payment of dividends.

The first step is the detection of the test of the business corporation using the solvency models or bankruptcy models but on the data from basis of the modified profit and loss statement based on value-creating activities. Provided the business corporation does not operate in the grey zone or in the zone signaling potential bankruptcy on the basis of these models it can continue to the next step of the detection. The second step is the detection of the modified achieved net result of the economic activity. The modified economic result adjusted by unrealized revenue and expenses from the main economic activity and also income and expenses of sale of fixed assets and material and income from subsidies and compensations from insurance company can be a positive value number, which means the company reached a profit or it can be a negative value number which means the loss was reached. Provided the modified economic result (earnings after taxes) is a positive the corporation can proceed to the

next step of the detection. The third step is the detection of the solvency value of the disposable undistributed profit of the previous years. At this established custom are first detects unpaid losses from previous years and if they exceed disponible profit of previous years the management of the business corporation have to propose to the general annual meeting of the owners the payment of the losses from the previous years.

The proposal of the modification this established custom consist in adding the correction of disponible profit for distribution by deduction of obligations arising from the title of taxes and insurance from wages that are overdue. The proposed correction is important for retaining liquid money for settling obligations towards the state and insurance companies so that the interests of the owner did not receive preference over the lawful obligation to pay taxes and insurance from paid wages. Provided the economic result after all these corrections is positive and there is a disposable profit it is possible to propose the payment of dividends through an approved method of the dividend policy.

4.5. Application of the proposed methodology for setting the modified calculation basis for the payment of dividends.

Detection of modified established customs and calculation of modified economic result on the basis of selected data from reporting and the general ledger of the real business corporation.

Table 3 Selected input data of the real business corporation, calculation of the economic result

Statement according to types of expences	In Thous. CZK	Modified statement	In Thous. CZK
Fixed Assets	62 753 Kč	Fixed Assets	62 753 Kč
Inventory	23 500 Kč	Inventory	23 500 Kč
Cash and Cash in bank	6 580 Kč	Cash and Cash in bank	6 580 Kč
Receivables short-term	10 500 Kč	Receivables short-term	10 500 Kč
Estimated revenue	952 Kč	Estimated revenue	952 Kč

Equity	2 000 Kč	Equity	2 000 Kč
Retained earning	25 900 Kč	Retained earning	25 900 Kč
Net Income	37 825 Kč	Net income	37 825 Kč
Liabilities current	27 100 Kč	Liabilities current	27 100 Kč
Tax liabilities	10 872 Kč	Tax liabilities	10 872 Kč
Estimated expences	588 Kč	Estimated expences	588 Kč
Service Revenues	202 646 Kč	Service Revenues	202 646 Kč
Performances consumption	80 432 Kč	Value-creating activities	107 683 Kč
(Value addend)	122 214 Kč	Gross profit or loss	94 963 Kč
Payroll	61 132 Kč	Other Payroll	34 864 Kč
Value adjustments (depreciation, Adjustments)	1 962 Kč	Other value adjustments	1 001 Kč
Other operating income	1 200 Kč	Other operating income	1 200 Kč
Received subsidies	1 130 Kč	Received subsidies	1 130 Kč
Income from sale assets	104 Kč	Income from sale assets	104 Kč
Other operating expences	14 813 Kč	Other operating expences	14 813 Kč
Operating profit	46 741 Kč	Operating profit	46 719 Kč
Interest paid	44 Kč	Interest paid	22 Kč
Financial profit	-44 Kč	Financial profit	-22 Kč
Income before taxes	46 697 Kč	Income before taxes	46 697 Kč
Income tax	8 872 Kč	Income tax	8 872 Kč
Net income / loss for fiscal period	37 825 Kč	Net income / loss for fiscal period	37 825 Kč

Income before interest and taxes	46 741 Kč	Income before interest and taxes	46 719 Kč
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Source: data from Register of Commercial Corporations (www.justice.cz), Author's processing

Testing of established customs for the payment of dividend according to the current state.

The first established custom is the solvency of the business corporation. Selected data obtained from a really existing business corporation (accounting unit) were used for the testing of the established custom. The IN95 model⁴⁴ (the Neumaier's) was selected from the available list of solvency models and bankruptcy models. The reason for the selection of this particular model is the applicability of Index IN95 for specific Czech accounting statements and the Czech enterprising environment and its 70 per cent success rate. This model does not operate with the market value of the corporation, that means, which allows its application also on business corporations that are not listed on the stock exchange. Another advantage of this model is the incorporation of insolvency index.

Equations 4 Equations of this model IN95⁴⁵

$$IN95 = V_1 * A + V_2 * B + V_3 * C + V_4 * D + V_5 * E - V_6 * F$$

A = Assets / Liabilities

B = Income before interest and tax / Interest paid

C = Income before interest and tax / Total assets

D = Revenue / Total assets

E = current assets / current liabilities

44 NEUMAIEROVÁ, I., NEUMAIER, I. 2005. INDEX IN05

45 AUTHORS OF THE ECONOMIC MODEL INKA NEUMAIEROVÁ AND IVAN NEUMAIER

$F = \text{overdue liabilities} / \text{Revenue}$

$V_1 \text{ až } V_6 = \text{weights of individual indicators}$

Equations 5 Calculation of the IN95 bankruptcy model according to the current statements

$$\text{IN95} = 0,34 * 2,75 + 0,11 * 1062,30 + 5,74 * 0,44 + 0,35 * 1,94 + 0,10 * 1,07 - 16,54 * 0,01$$

$$\text{IN95} = 120,93$$

On the basis of the result of the bankruptcy model IN95 it can be said that the business corporation is in good state and is not threatened by bankruptcy.

It is therefore possible to continue with the second established custom which is the reached economic result (earnings after taxes, EAT) for the current accounting period (year).

Table 4 Profit according to types of expenses

Items statement	In Thous. CZK
Revenue	202 646 Kč
Performances consumption	80 432 Kč
Payroll	61 132 Kč
Value adjustments	1 962 Kč
Other operating income	2 434 Kč
Other operating expenses	14 813 Kč
Operating profit	46 741 Kč
Financial income	0 Kč
Financial expenses	44 Kč
Financial profit	-44 Kč
Profit before taxes	46 697 Kč

Income tax	8 872 Kč
Net income for fiscal period	37 825 Kč

Source: data from Register of Commercial Corporations (www.justice.cz), Author's processing

According to entry data of the selected really existing corporation it can be said that the accounting profit of 37.825 thousand CZK was reached.

It is therefore possible to continue to testing the third established custom which is the solvency of the disponible undistributed profit. Also in this case the entry from capital entries data of an existing corporation will be used for the testing.

Table 5 Retained earnings under current rules

Items	In Thous. CZK
Retained earning	+25 900 Kč
Retained loss	0 Kč
funds from profit / Reserves	0 Kč
Net Income	+37 825 Kč
Available profit to divide	63 725 Kč

Source: data from Register of Commercial Corporations (www.justice.cz), Author's processing

The value of the undistributed profit from previous years reaches 25.900 thousand CZK. Real business corporation does not report any unpaid loss from previous years and does not create any funds from the profit. The total disposable profit for the payout is 63.725 thousand CZK.

Liquidity index as a complementary established custom

Equation 6 Cash Position Ratio

$$\text{Cash Position Ratio} = \frac{\text{Financial Assets}}{\text{Current liabilities}}$$

$$\text{Cash Position Ratio} = \frac{6\,580}{37\,972} = 0,17$$

$$\text{Cash Position Ratio} = 0,17$$

The Cash Position Ratio for the purpose of testing the solvency of the business corporation for the payment of dividends is 0.17. This value is insufficient.

Testing of established customs for the payment of dividends according to the modification proposal.

The first established custom is the solvency of the business corporation.

Equations 7 Calculation of the bankruptcy model IN95 on the basis of modified statement

$$\text{IN95} = 0,34 * 2,75 + 0,11 * 2123 + 5,74 * 0,45 + 0,35 * 1,94 + 0,10 * 1,07 - 16,54 * 0,01$$

$$\text{IN95} = 237,66$$

On the basis of the bankruptcy model IN95 on the basis of modified reporting it is possible to say that the business corporation is in good state and is not threaten by bankruptcy.

The second established custom is the modified economic result (EAT) for the current accounting period (year).

Table 6 Modification of accounting result

Items	In Thous. CZK
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Servis revenue	202 646 Kč
Value-creating activities	107 683 Kč
Gross profit or loss	+94 963 Kč
Payroll	34 864 Kč
Value adjustments	1 001 Kč
Other operating income	2 434 Kč
Other operating expenses	14 813 Kč
Operating profit	+46 719 Kč
Interest paid	22 Kč
Financial profit	-22 Kč
Income before taxes	+46 697 Kč
Income tax	8 872 Kč
Net income / loss for fiscal period	+37 825 Kč
Estimated revenue or income (main activity)	-952 Kč
Income from sale assets	-104 Kč
Received subsidies	-1 130 Kč
Estimated expenses (not realized)	+588 Kč
Modified income / loss for fiscal period	+ 36 227 Kč

Source: data from Register of Commercial Corporations (www.justice.cz), Author's processing

Based on the modified reporting the modified economic result was 36.227 thousand CZK. Which means an accounting profit was reached.

The third established custom is the solvency of disposable undistributed profit.

Table 7 Modification disposable undistributed profit

Items	In Thous. CZK
Retained earning	+25 900 Kč
Retained loss	0 Kč
Funds from profit / Reserves	0 Kč
Modified income / loss for fiscal period	+36 227 Kč
Overdue tax liabilities (10 872 - 8 872)	-2 000 Kč
Modified available profit to divide	+ 60 177 Kč

Source: data from Register of Commercial Corporations (www.justice.cz), Author's processing

The amount of undistributed profit from previous years reaches 25.900 thousand CZK. The selected real business corporation does not report any unsettled loss from previous years and does not create any funds from profit. The modified total disposable profit is adjusted by liabilities towards the state that are overdue and also by the modified economic result in the current accounting period (year). The total disposable profit for payout of dividends is 60.177 thousand CZK.

Additional established custom the liquidity index Cash Position Ratio

Equation 8 Cash Position Ratio

$$\text{Cash Position Ratio} = \frac{\text{Financial Assets}}{\text{Current liabilities}}$$

$$\text{Cash Position Ratio} = \frac{6\,580}{37\,972} = 0,17$$

$$\text{Cash Position Ratio} = 0,17$$

The Cash Position Ratio for the purpose of testing the solvency of the business corporation for the payment of dividends according to modified statements is 0,17. This value is insufficient.

4.6. Comparison of evaluation of the current situation in testing according to established customs for the calculation basis for the payment of dividends with the proposed modified model of calculation basis for payment of dividends.

When the comparing the established customs required for setting the calculation basis for payment of dividends we can come to the following conclusions.

Table 8 Evaluation of the results of detection of established customs

Current status	Value	Proposed modification	Value
Solvency corporation	120,93	Solvency corporation	237,66
Net profit	37 825 tis. Kč	Net profit	36 227 tis. Kč
Available profit to divide	63 725 tis. Kč	Modified available profit to divide	60 177 tis. Kč
Liquidity	0,17	Liquidity	0,17

Source: data from Register of Commercial Corporations (www.justice.cz), Author's processing

When comparing the first established custom we can say that the modification in reporting led to improved result in the test of solvency. Differences in individual indexes of the bankruptcy model are in the height of interest reported in financial expences. Modified reporting includes costs of outside capital, which is used for financing projects and orders into the entry value-creating activities. Other interests expences which cannot be linked with projects are accounted

in financial expenses. This reevaluation of interests expenses in the calculation of value-chains influences the value of EBIT (Earnings before Interest and Taxes). The resulting values of both versions of bankruptcy models showed high solvency of this selected real business corporation.

Comparison of the results of the second established custom, show difference in the height of 1.598 thousand CZK of the net economic result that can be paid out as dividends to the owners. While in the current situation the net result includes all revenue and expenses, that is those, realized that bring profit and cash flow as well as those unrealized, that in the current accounting period do not contribute in any way to the liquidity and solvency of the business corporation and do not increase cash flow in the given accounting period (year). Owners of the business corporation therefore can pay themselves out dividends and draw cash from that part of the economic result, which in the end not be created. According to current legislation the owners are not obliged to return the dividend in the following accounting period (year) if the unrealized revenue, that is those entered into accounts through estimated items do not the estimated height in the final accounts. The business corporation only dissolves or adjusts the height of the estimated items in the following accounting period and sends additional tax declaration and rectify the amount of tax. The business corporation gets into a situation when it lacks finance for reinvestment and development of the enterprise and may become insolvent.

The proposed modified economic result which is the calculation basis for the payment of dividends eliminates these absurdities and excludes these items from the economic result. The aim of this elimination is the protection of the business corporation from unjustified outflow of financial means from the corporation and its protection from insolvency. Among the other absurd situations could be included the payment of dividends from income from subsidies or insurance compensations that are aimed to cover losses and operational expenses. Instead they increase the economic result and by that the calculation basis for the payment of dividends.

The comparison of the results of the third established custom shows the difference 3.548 thousand CZK of disposable profit that can be used to pay the dividends to the owners. Currently, the retained earnings include undistributed profit of previous years together with the economic result of the current accounting year lowered by the payment of possible losses of previous years and voluntary transfer into funds. Similarly as in the previous established custom, are in the disposable profit included also unrealized income and expenses from subsidies and insurance compensations, that can intentionally overestimated the net economic result (EAT). Another factor that is not taken into account are the overdue obligations. The owner pay themselves the dividend not only from the unrealized revenue but also withdraw

finance from the business corporation without consideration of the unpaid obligations towards the state, which is the obligations arising from tax and insurance. The presented example of the selected real business corporation includes only obligations towards the state but the management should include into this item also overdue obligation arising from leasing repayments, loans and so on, as to act with prudent and appropriate care (diligence). The proposed modified disposable profit that can be paid out in the form of dividends eliminates this entry of unpaid overdue obligations and not includes this item into the calculation of the disposable profit. The aim of this elimination is the protection of the business corporation against the unjustified outflow of finance from the corporation and potential bankruptcy.

Additional index for evaluation of established customs is the index of liquidity Cash Position Ratio. Liquidity according to current and modified state reaches the value 0,17. This value is lower than the recommended values. This means that the payment of dividends and the outflow of finance will put the management of the business corporation into insolvency and this might lead to a situation when the management will take to a loan for the dividends payment and then to will pay the interest from the loan. Such a behaviour can be seen as extremely irresponsible. That is why this index should be taken into consideration when deciding about the payment of dividends.

By the overall evaluation of the detection of established customs for the calculation base for the payment of dividends in the example of the selected real business corporation we can conclude that the proposed modified reporting and the proposed modified calculation base leads to retention of the amount 3.548 thousand CZK, which can be used by the business corporation for its development without considering its dividend policy and the payout ratio.

5. Financial planning

The objective of the financial planning is to set the amount of financial resources to ensure solvency and financial stability for the financing of planned projects, investment, current operational activities but also for the planned amount of required dividends for the owners. The management of the business corporation creates a budget of resources within the framework of management of working capital and plans the balanced use of these resources.

Table 9 Balance of resources and the use of the resources

Sources	Use of resources
Profit	Loan repayment
Depreciation	Increase in working capital
Operation cash flow	Investments
Long-term loans	Distribution of dividends to owners
Reduction in working capital	---
Additional deposits in share capital	---

Source: KRAUSEOVÁ, J., a kol. Zakladatelský finanční záměr firmy do kapsy, Author's processing

From the perspective of cash flow it is necessary, however, to exclude from the profit revenue and expenses, which are not income or payments. Management of the business corporation therefore has to, within the financial planning and budgeting use methods of appraisal of individual items of the balance in such a way as to rectify these differences.

Depreciation belongs to entries that within the economic result do not bring any cash flow but are items that lower the tax base for the income tax of legal entities (corporate tax). The lowering of tax obligation leads to savings of financial means. That is why depreciation is included into the group of financial resources. Operational cash flow and financial loans are the cash flow itself. Therefore there is no doubt about inclusion of these items into financial resources. Item reduction in working capital is related with the amount of registered inventory and the amount of receivables. Provided the business corporation manages well the working capital it is their daily concern to minimize the amount and number of receivables as they can lead to lowering of liquidity and solvency. Inventory control has its specific features that reflect the main economic activity of the business corporation.

The main economic activity of the selected real business corporation chosen as an example is the field of projecting and planning. It means that the management have to check in regular intervals individual phases of the projects and detect digressions from the planned calculation. A special situation occurs in the time of preparation for the final accounts (closing of the books), when within the framework of the final accounts operations the valuation of the inventory of

work in process is done on the cause related expenses. The value of these specific inventory and through them the value of the working capital can be corrected only through deposits received for individual stages of the project. Payments for received deposits increases the value of the monetary part of the working capital, which means the rise of usable resources. The balance of resources and their use gets equalized. Another source are further input into the basic capital. It is a direct cash flow which does not need to be modified in any way. It is connected with financial expenses for fees, for example for the notary, for the inscription into Public Registry and so on.

The other side of the balance is formed by repayments of loans that are a cash flow in themselves and do not need to be modified. They are connected with financial expenses that is the cost of capital that have to be included in this balance. Increase or decrease of the working capital is influenced by the amount of receivables, inventory and also the height of short-term liabilities. The management of the business corporation has to follow the same rule as in the case of receivables. It is necessary the regularly check the value of receivables and liabilities (accounts payable) with the aim of keeping the cash flow positive. The investment entry is closely related to long term resources, own capital (created by positive economic result) or outside capital (long-term loans). The cash flow resulting from an acquisition is connected with financial costs of capital which have to be projected into cash flows.

The distribution of dividends to owners is part of the strategic policy of the corporation which consist in setting the selected dividend policy. The cash flow required by the owners had to be adjusted by a number of tests and models, that are mentioned in this paper as to prevent the insolvency or potential bankruptcy of the business corporation caused by payment of dividends. The minimal necessary profit model⁴⁶ can be used for this purpose. This model includes all items necessary for planning of the economic result and it a supplement for planning annual cash flows.

46 FETISOVOVÁ, E., A KOL. 2005. PODNIKOVÉ FINANCIE.

Equation 9 Equation for the calculation of minimal necessary profit ⁴⁷

$$EAT = \frac{D(P - O) + RF + OF + Div + I}{1 - D}$$

EAT = Net profit after tax

D = Tax rate

P = Credited items

O = Deductible items

RF = Reserve Fund

OF = Other Fund

Div = dividends

I = Investments

The minimal necessary profit model uses a system of adjustments of the economic result for tax base for the purpose of the income tax of tax of legal entities. It also predicts required values of contributions into reserve funds in accordance with the statutes and directives of the business corporation. The prediction also contains the value of required height of dividends payout and the amount of planned investments (payout ration).

This model, however, does not take into account modifications proposed in this paper. Particularly the modified economic result which excludes unrealized revenue and expenses from the main economic activity, income and expenses from the sale of fixed assets and also specific subsidies and insurance compensations that are aimed to cover damages and operation expenses. Another not reflected modification of this model is the modified disposable profit for distribution of dividends which correct the disposable profit by the value of unpaid liabilities arising from taxes and insurance of wages that are overdue.

Financial planning and budgeting within the business corporation should always stem from an array of applicable balance, profit and disposable profit models that will gradually be adjusted by the modification.

47 FETISOVOVÁ, E., A KOL. 2005 PODNIKOVÉ FINANCIE.

6. Discussion on projection of the proposal for modification into legislative regulations and political willingness incl. corporations

The modification of calculation basis for the payment of dividends and its advantages should also be reflected into current valid legislation via amendments of the laws and decrees. There is a question of discussion: both factual and political willingness.

How to implement the proposed modifications of reporting and the methodology of evaluation and accounting into the Czech Republic legislation?

The first act that should be amended is the Act No. 90/2012 Coll. on Commercial Companies and Cooperatives (Business Corporation Act). Sections 51 to 53 of this Act contain „*Rules of conduct for members of a body*“ (statutory members). There is no need to revise this regulation, because this regulation include assessed, that a member of a body of a business corporation have to act with due care, and the burden of proof shall be upon such member. The material that should be required as a proof are the calculations of value-creating activities, financial plans and budgets of required revenue, net profit, analysis of indexes of financial analyses and the detection of solvency of the business corporation. The documentation of dividend policy should be an essential part as well. There is an option to include this information into the commentary of the Business Corporation Act.

Business⁴⁸ Corporation Act. regulates the payment of dividends in sections:

„Section 40, part 1. „Profit or funds from other own resources, including advance payments for this purpose, may not be paid out by a business corporation if the same could result in its insolvency under another legal regulation“.

„Section 161, part 4. „The amount to be distributed among the owners may not exceed the amount of profit for the accounting period just ended, increased by the retained profits from previous years, less the accumulated losses from previous years and contributions made to the reserve fund and other funds in accordance with this Act and the memorandum of association“.

48 ACT. N. 90/2012 SB., ZÁKON O OBCHODNÍCH SPOLEČNOSTECH A DRUŽSTVECH, V PLATNÉM ZNĚNÍ

Section 350, parts 1 and 2 „(1) *A company may not distribute profit or other own resources among its shareholders if, as at the last date of the accounting period just ended, its equity as shown at the regular or extraordinary financial statements or its equity after such profit distribution will fall below the amount of the subscribed registered capital increased with the funds which cannot be distributed among the shareholders pursuant to this Act or the articles of association*“ . „(2) *The amount to be distributed among the shareholders may not exceed the amount of profit (loss) of the accounting period just ended increased with the retained profits from previous years, less the accumulated losses from previous years and the contributions made to the reserve fund and other funds in accordance with this Act and the articles of association.*“

Particularly in Section 161, part 4. and in Section 350, parts 1 a 2, is grounded the profitability test for limited liability companies and profitability test and equity (shareholder's capital) test for joint stock companies. The proposed amendment should be reflected in the Section 161 of the Corporations Act and include test of equity in the limited liability company and in Sections 161 and 350 where the modified version of the disponible profit should be included.

The second law that should be amended is Act No. 563/1991 Coll⁴⁹. on Accountancy in its valid form. According to Section 25, part 1, it appreciate particularly on individual assets and obligations: *method of acquisition costs, inventory and assets created internally by production expences, in the case of monetary means at their nominal value, in the case of ownership interests, securities and derivatives at their acquisition cost, in the case of inception of a receivable at the nominal value, but at the acquisition cost, in the case that a receivable is acquired for a valuable consideration or as an investment contribution, and at the nominal value in the case of commitments.* “

The proposed amendment should add to the list in Section 25, part 1, after parts a) to l), new part m) according to which all outputs should be evaluated by using the value-chain method (value-creating activity).

49 ACT. N. 563/1991 SB., O ÚČETNICTVÍ, V PLATNÉM ZNĚNÍ

Table 10 Formula for the value-chain

Value-creating activities +
Margins +
Total expenses of the project

Source: Author's processing

The Decree which should also be amended is the Decree 500/2002 Coll., which specifies the practical application of Act No. 563/1991 Coll. on accountancy, in the amended currently valid form for accounting units that are entrepreneurs using the double entry accounting. According to Head III of this Decree is the specification of the items of the Profit and loss statement. The proposed amendment should change the wording of sections 20 to 38 and replace them with the items of the modified Profit and loss statement in purpose oriented classification and to a new separate section add the equation of the modified economic result for the payment of dividends.

Table 11 Proposal of modified Profit and loss statement according to the Value chain method

Number	Items
1.	Service revenue +
2.	Merchandise revenue+
3.	Value-creating activities -
*	Gross profit or loss +/-
5.	Other operating income +
6.	Other operating expences -
**	Operating profit or loss +/-

Source: Author's processing

The amendment of the Decree⁵⁰ should change and add to the texts about the obligatory items of the Final accounts. According to Head IV of this Decree the arrangement and content definition of explanatory and additional information in the supplement of the Final accounts, contained in Section 39 to Section 39c depending on the size of the accounting unit. Information required according Section 39, part 1 b) of the Decree: *„Accounting unit shall include in the Attachment of the Final accounts statement general information about the accounting unit, information about the general accounting principles used and accounting methods applied and differences to these methods according to the principle of their significance.“* These directives need not be amended altered because it is general character and includes the requirement of the proposed modified for evaluating all output by using the value-creating chain (value-creating activities).

Information required in Section 39, part 1 g) of the Decree: *„The accounting unit shall also include in the Final accounts the total amount obligation relationships, average number of personnel during the accounting period, also the character and size of the individual items of revenue and expences that are extraordinary by their size or origin.“*

The proposed amendment should add the text of Section 39, part 1 g), with the obligation to include specification of expenses of services. Items *„Services included in value-creating activities“ and Services of operational charakter.“* The objective of this amendment is the more detailed reporting of these accepted services, that are considered the most controversial items of the reporting in the area of economic result and would lead to detection of frauds in accounting and fictitious services aimed at lowering the tax base for the corporate tax and therefore tax obligation.

The other accounting standard that should be amended is the Czech Accounting Standard (Český účetní standard ČÚS) No. 019,⁵¹ which regulates the procedure of accounting of expenses and revenue. According to Parts 3.1 and 3.2 of this Standard are accounted expenses according to individual groups of accounts.

The amendment of this Standard should change the text of Part 3.2, which regulates *„the accounting of consumed purchases in accounts of the accounting group 50“ and Part 3.3, which*

50 DEGREE N. 500/2002, SB., PROVÁDĚCÍ VYHLÁŠKA K ÚČETNICTVÍ, (ACT NO. 563/1991 COLL. ON ACCOUNTANCY)

51 CZECH ACCOUNTING STANDARD NO. 19, ÚČTOVÁNÍ NÁKLADŮ A VÝNOSŮ

regulates „accounting of services on accounts of the accounting group 51“ and to amend these Parts by methodology of accounting value-creating activities cause related with a project (order). Other revenue and expenses not related with the value-creating activities would be accounted in accordance with the other Parts of the Standard.

The second topic of discussion.

Can the retained profit of previous years for re-investment be included in the following year into disposable profit for the payment of dividends?

The answer to this question is rather sensitive. According to entry data in the example of a selected real business corporation (Table 3), the undistributed profit of previous years is the amount of 25.900 thousand CZK.

Provided the general annual meeting of the owners in the year when they approve the economic result of 25.900 thousand CZK decide that the profit reached would not be distributed and will be transferred into undistributed profit of previous years the answer would be that the undistributed profit can be included into the modified disposable profit for the payment of dividends in the following year.

However, if the general annual meeting of the owners in the year when they approve the economic result of 25.900 thousand CZK decide that this profit should be retained for re-investment the inclusion of the amount 25.900 thousand CZK into the modified economic result in the following year could be viewed as unjustified. The reason is the fact that every investment has its payback period. The management of the business corporation should evaluate the advantages and disadvantages of every investment at least according to investment payback criteria, profitability rate, internal rate of return, the internal yeald percentage and net present value and also the capital recovery period.

Equation 10 Return on Investment Period „T“⁵²

$$T = \frac{IN}{CF}$$

IN = Investment

CF = annual income – expenses savings due to the investment

This index measures the number of years after which the initial capital costs is offset against the received cash receipts. In a formula, its denominator can include discounted cash flow (DCF).

Equation 11 Profitability rate of investment „R“⁵³

$$R = \frac{\text{profit from the investment}}{\text{investment expenditure}}$$

This index measures profitability of the investment which lies in the faster cash flow.

Equation 12 Internal rate of return „IRR“⁵⁴

$$I - DNCF = 0$$

I = Investment

DNCF = discounted net cash flows

This index measures what % of the investment will be yield for the corporation if we take into account the time value of money.

52 KRAUSEOVÁ, J., A KOL. 2007. ZAKLADATELSKÝ FINANČNÍ ZÁMĚR FIRMY DO KAPSY. 1. VYDÁNÍ. PRAHA. MELANDRIUM. 2008. PP. 107 – 111. ISBN: 978-80-86175-54-6.

53 KRAUSEOVÁ, J., A KOL. 2007. ZAKLADATELSKÝ FINANČNÍ ZÁMĚR FIRMY DO KAPSY. 1. VYDÁNÍ. PRAHA. MELANDRIUM. 2008. PP. 107 – 111. ISBN: 978-80-86175-54-6.

54 IBIDEM

Equation 13 Capital Recovery Period „TC“⁵⁵

$$TC = \frac{\text{total invested capital}}{\text{Net profit} + \text{depreciation}}$$

Provided the amount 25.900 thousand CZK of retained profit from previous year was used to finance investments and the return of investments is calculated for four years it is possible to include this retained part of disposable profit into the modified disposable profit for the payment of dividends only after four years when the return of the investment is realized and a profit from this investments is reached.

The third question for discussion.

How will the proposed modification influence the economic result, reporting and methodologies of evaluation and accounting the indicator EVA (Economic Value Added)?

Economic Value Added index is constituted on the basis of accountancy. Individual values included into the calculation of economic value of the corporation have to be transformed and cleaned from non-operational items.

Equation 14 Formula for calculating the economic value added of an enterprise (EVA)⁵⁶

$$EVA = NOPAT - WACC * C$$

NOPAT = profit from operating activities

WACC = weighted average cost of capital

C = invested capital

55 IBIDEM

56 KISLINGEROVÁ, E., A KOL. 2010. MANAŽERSKÉ FINANCE. 3. VYDÁNÍ. PRAHA: C.H.BECK. 2010. PP. 383 – 418. ISBN: 978-80-7400-194-9.

Table 12 Transformation of accounting items for the calculation of EVA

Operating profit before tax
+/- Correction of operating profit
Correction operating profit before tax
+/- Changes in reserve balances
+/- Other correction operating profit
Correction operating profit before tax
- Taxation of modified operating profit
Net operation profit after tax (NOPAT)
Weighted average cost of capital
Invested capital
Minimum required return on invested capital
„EVA“ Economic Value Added

Source: KISLINGEROVÁ, E., a kol. Manažerské finance. p. 261., Author's processing

The proposed modification of methodology of evaluation and accounting of the main economic activity would significantly contribute to simplification of the transformation of the accounting operational economic result into the revised economic result, which is one of the values used for the calculation of the EVA indicator. All expenses calculated to output according to the value-creating chains (activities) are linked to cause related expenses projects and together with the revenue of these projects create the gross earnings (economic result) of the main economic activity (Table 6). This gross economic result from the main economic activity can be compared to the revised economic result before tax. The items of the change of reserves and other changes of the operational result before tax (Table 12) are divided in the proposed modification of evaluation and accounting as well as all other expenses according to causation with the project or according to their character as purely operational. Reserves and other items that are cause related with the project belong to the gross economic result of the main economic activity and those expenses that are of operational character would be accounted in the entries of other operational expenses (Table 6). Other values necessary for the calculation

of the economic value of the corporation are revised on the level of operational assets and invested capital. In these items the procedure would be identical.

Accounting is primarily considered an information system which provides the management, investors and other institutions with the necessary information about the business corporation through the common final accounts. According to Czech legislation final accounts include the balance sheet and profit and loss statement in some cases the overview of the cash flow and the overview of equity and descriptive attachment final statement. The comparability of final statements and particularly account statements⁵⁷ according to Czech accounting standards with statements created according to international⁵⁸ accounting standards (IFRS, International Financial Reporting Standards) and comparability with account statements according to American⁵⁹ accounting standards (US GAAP Generally Accepted Accounting Principles) are still on a relatively low level.

The paper is aimed on the proposal of modification of the calculation basis for the payment of dividends to owners which is primarily based on the economic result after tax. According to American US GAAP standards and in agreement with the international standards IFRS are estimates considered untrustworthy sources of accounting information and must be excluded from accounting systems and accounting statements as much as possible. The incomparability of the final statements according to IFRS and US GAAP with the Czech profit and loss statement lies in the difference in accounting procedures. The IFRS statement and the US GAAP is constituted of operational part which is aimed at the main economic activity and the non-operational part which contains the profits and losses in other activities. Final accounts according to IFRS and US GAAP contain a part of so called underlying items among those belong, for example aggregate affects from changes of methods and so on. Documents SFAS 130 (Statements of Financial Accounting Standards), US GAAP added another part to the final accounts which contains the changes in capital or unrealized gains and losses. Another important difference in statements is the eligibility of revenue and expenses that is when it is

57 WHEN COMPARING THE FINANCIAL STATEMENTS UNDER CZECH ACCOUNTING STANDARDS AND INTERNATIONAL ACCOUNTING STANDARDS, OR US ACCOUNTING STANDARDS, AS PUBLISHED IN PUBLIC REGISTERS, COMPARABILITY IS LOW. THIS FACT IS CONFIRMED IN HER PROFESSIONAL PUBLICATION IFRS BY KRUPOVÁ AND ALSO BY MLÁDEK IN HIS PROFESSIONAL BOOK WORLD ACCOUNTING. THE TRANSFORMATION OF CZECH REPORTING TO INTERNATIONAL OR AMERICAN IS POSSIBLE, BUT REQUIRES KNOWLEDGE OF THE DIFFERENCES BETWEEN CZECH (CZECH GAAP), INTERNATIONAL (IFRS) OR US GAAP AND IS MORE TIME-CONSUMING.

58 KRUPOVA, L. 2009. MEZINÁRODNÍ STANDARDY ÚČETNÍHO VÝKAZNICTVÍ

59 MLÁDEK, R. 1998. SVĚTOVÉ ÚČETNICTVÍ

possible to account a revenue or expenses. Revenue can be accounted only in the period when they were earned. This means there are proofs that they were realized and also there exists a promise of payment. Expenses can be accounted only linked to existing revenue in the period when the revenue are accounted.

In professional literature and in specialized journals the discussion of dividend policy and payment of dividends concentrates on the increase in the amount of dividend from the owner point of view or comparison of individual models of the dividend policy in relation to financing of corporations projects. Strategic planning of dividend policy is important both for the management of the business corporation as well as for the owners. However, until removed seriously distorting and overvaluing items of the calculation base for the payment of dividends, which is the main task of the accounting legislation are removed and revised there will be the higher outflow of finance from business corporations.

7. Conclusion

Creative accounting helps distort data in accounting. These undesirable intentions can be identified in many cases. The presented theme is another topic to be explored in addition to analyzing specific risk areas in corporate accounting in the context of fraud detection in selected areas. 1. Detection of fictitious services in performance consumption. 2. Importance of transfer prices and their documentation for holdings in the context of potential misrepresentation of income statement and income tax base. 3. Payout ratio, and its impact on return on invested capital to owners (investors).

The proposed modification of calculation basis for the payment of dividends according to Czech accounting standards aims at improvement of comparability of Czech statements with the international standards and the American accounting standards. It is particularly aimed at the amendment and alteration of accounting legislation so that the reporting of gross economic result from the main economic activity would become more transparent.

The methods of evaluation on the basis of value-creating activities and cause related expenses will allow the management, investors and other institutions detect what margin does the business corporation use because the gross economic result includes all revenue and expenses that are related to the main economic activity. The proposed modification of the

calculation basis will decrease the importance of overrated unrealized revenue for the payment of higher dividends to the owners and through that decrease the outflow of finance from the business corporation.

8. Resources

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