Role of Culture and Law Enforcement in Determining the Level of IFRS Adoption

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Abstract:

This article investigated why IFRS adoption was in fact implemented differently in many countries around the world.

We proposed two possible variables to determine a country adopting IFRS, in terms of cultural and law enforcement.

We also proposed a measurement model of IFRS adoption level. We predict and find that countries with a high power distance level are likely to have low IFRS adoption level, and countries with a high law enforcement level are likely to have high IFRS adoption level.

Keywords: *IFRS, National Culture, Law Enforcement, International Accounting Standard.*

JEL Classification: *M41, M48.*

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1. Introduction

In 2002, the European Parliament established a rule that the companies listed on the stock exchange of the European Union are required to apply international accounting standards known as the International Financial Accounting Standards (IFRS) issued by the IASB for the latest in the financial reporting year 2005. Since then, many countries have been applying IFRS. Australia has obligated the IFRS application for all companies in the country since 2005, while Russia has made the obligation since 2004. The conference of the group member of 20 (G20) on November 15, 2008 in Washington DC declared the principles of capital market reforms, including the reinforcement of capital market transparency and accountability by implementing high-quality international accounting standards on the companies listed in capital market.

The application of international accounting standards is expected to create a positive impact on the capital market of the adopting countries. Pacter (2003) explains the advantages of IFRS application, including providing access for foreign investors, lowering capital cost, and increasing the understanding of financial statements. The chairperson of the International Accounting Standards Board (IASB) as the constituent of IFRS, Sir David Tweede in Packer (2003) describes the importance of international accounting standards to eliminate obstacles in accounting. The obstacles include the absence of national accounting standards and the problems in financial reporting (Suryanto and Thalassinos, 2017).

Although IFRS is considered as a high quality accounting standard, the IFRS implementation is addressed differently by stakeholders. Armstrong *et al.* (2010) shows that the IFRS application is positively responded by the investors previously using low quality accounting standards. However, it receives a negative response from investors in countries with a legal system of code law.

In fact, IFRS is adopted differently in each country. IFRS adoption process is divided in two schemes. First, the full adoption as implemented by Malaysia, Singapore, Brazil, and second, the gradual adoption as implemented by Indonesia and China. Zeff and Nobes (2010) explain that the IFRS adoption in each country is carried out in different ways, including full IFRS adoption, IFRS adoption in accordance with the country condition, full convergence, and partial convergence. The application of accounting standards in a country is determined by national goals, political, economic, and cultural systems in the country (Suwardjono, 2005; Kurniawan, 2017; Munawarah *et al.,* 2017). This fact shows that internal factors of a country determine the extent to which the country will adopt IFRS.

Gray (1988) reveals that culture is one important factor determining the application of particular accounting standards in a country. Hofstede (1983) defines culture as a collective and difficult-change thought distinguishing one society to others. Hofstede divides culture into four main dimensions, including individualism, power distance,

uncertainty avoidance, and masculinity. In addition, the successful implementation of accounting standards in a country is determined by the law enforcement and conformity in the country (Karampinis and Hevas, 2009; Liapis and Thalassinos, 2013; Thalassinos *et al.,* 2015).

Therefore, this study aims to examine the influence of culture and law enforcement on the level of IFRS adoption in a country. Furthermore, this study is intended to improve the literature in explaining the phenomenon of the IFRS adoption and the relation to the characteristic of each country in terms of culture and law enforcement. In addition, this study is expected to be a useful reference for decision makers to consider the internal factors of the country for the IFRS adoption.

2. Literature Review and Hypotheses

2.1 National Culture

Hofstede (1983) defines culture as a collective and difficult-change thought distinguishing one society to others. For instance, contemporarily, in terms of using social media, although technology are borderless, there are no single platform that can be used unanimously in international level, in which some cultures have their own distinctive measures (Budiharseno, 2017; Nugroho *et al*., 2017). Culture is also defined as a set of behavior pattern socially streamed symbolically through language and other means to the members of a particular society (Wallendorf and Reilly, 1983; Din *et al.,* 2017). This study identifies culture in four dimensions proposed by Hofstede (1983), including individualism, power distance, uncertainty avoidance, and masculinity, based on the survey conducted in 1968 to 1972.

2.2 Power Distance

Power distance indicates the acceptance level by the less powerful society members stating that the power has been unevenly distributed. The fundamental issue in this dimension is how people respond to inequalities in the society. Society members with a high power distance level accept the hierarchy positioning each individual in a low or high position without justification or reason. On the other hand, society members with a low power distance level attempt to balance the authority of each member and demand a justification if there is inequality of power.

2.3 Individualism

Individualism is defined as a social preference of which an individual in a society is expected to take care of himself and his family. In a society with a high individualism level, individuals simply take care of themselves and avoid taking care of other people's problems unrelated to them. On the other hand, in a society with a low individualism level, individuals show caring attitude and have loyalty to the

society members, commonly called as collectivism. The fundamental difference between individualism and collectivism is reflected in the image terms "I" or "we".

2.4 Masculinity

A society with a high masculinity level shows the collective public interest to achievement, heroism, assertiveness, and reward in the form of materials for success. On the other hand, a society with a low masculinity level shows cooperation, simplicity, comfort and life quality, or so-called as femininity.

2.5 Uncertainty Avoidance

The dimension of uncertainty avoidance indicates the extent to which members of a society feel uncomfortable against uncertainty and ambiguity. The basic issue in this dimension is how people accept the fact that the future is unpredictable. A country with a high   uncertainty avoidance level formulates many regulations and less likely to accept unusual behaviors and ideas. On the other hand, a country with a low uncertainty avoidance level has less tight behavior rules, and upholds principles more than rules.

2.6 Law Enforcement

Law enforcement is the process of upholding and functioning legal norms factually as a behavioral guidance or legal relations in the society. Law enforcement is able to be conducted by a broad subject, and is able to be interpreted as law enforcement efforts by the subject in a limited or narrow sense. In a broad sense, the law enforcement process involves all legal subjects in every legal relationship. Those, who run a normative rule, do something, or do not do something based on the norms and applicable law rules, are running or enforcing the law. In a narrow sense, the law enforcement is defined as an effort by a particular law enforcement apparatus to guarantee and ensure that a law works as it should (Asshiddiqie, 2013).

In this research, law enforcement is defined as the extent to which a party has a guarantee and assurance of the rights based on the state law (legal rights). The legal rights of a country are measured by the availability and enforcement of legal rules guaranteeing the protected citizens' rights. The measurement is presented in a legal right index to compare the legal rights of each country.

2.7 IFRS Adoption

International Financial Reporting Standards (IFRS) are accounting standards developed by the International Accounting Standards Board (IASB) functioning as an international standard to ensure uniformity in a high quality financial reporting. However, IFRS adoption process is not   same between countries. From 2003 until 2008, there were more than 50 countries requiring the IFRS application on

companies listed on capital market, 15 countries allowing companies to adopt IFRS, and 15 countries currently implementing the convergence project in accordance with IFRS accounting standards. Until 2008, the countries that had not been implementing IFRS, included United States and China, regarded as the world economic giants (Ramanna and Sletten, 2014).

The difference in IFRS adoption is possibly caused by the varied impacts of the adoption. There are a similar number of studies stating that IFRS application equally increases and decreases the accounting quality (Ahmed *et al.,* 2013). Barth *et al.* (2008) states that there are, at least, three reasons behind the improved quality of accounting caused by the IFRS adoption. The reasons are that IFRS eliminates several alternative methods of accounting, thereby reducing the management discretion; IFRS is a principle-based standard, thereby making it more difficult to be cheated; and the measurement in IFRS focuses on fair value, thereby improving the relevance of the financial statements. However, IFRS application is also able to reduce the accounting quality since the basic principle of IFRS is unaccompanied by guidelines, thereby providing greater flexibility for management to determine the appropriate expected accounting treatment.

2.8 Culture and IFRS Application Level

In the process of financial reporting, engineering, economic and social objectives of a country have an important role as the original purpose of financial reporting (Suwardjono, 2005). This explains that accounting standards are formulated based on the different characteristics and objectives of each country. The difference in characteristics is possible in terms of geographic, economic, cultural, social, and legal conditions. Focusing on the culture of a country Hofstede (1983) divides the cultural characteristics in several dimensions, including power distance, individualism, masculinity, and uncertainty.

2.9 Power Distance and IFRS Adoption Level

Countries with a high power distance level are likely to consider that instructions from the higher hierarchy are a rule that should be applied. In this concept, the role of decision makers and implementers has clear limitations. Chan *et al.* (2003) explains that in countries with a high power distance level, the absence of instructions from the management leads to the higher probability of accounting errors.

Accounting standards based on rules set by the Financial Accounting Standards Board (FASB) are previously and frequently used as a reference to accounting standards in various countries. On the other hand, IFRS formulated by the IASB is structured as accounting standards-based principle, causing the detailed instructions is quite less. This is caused by the standard application requirring professional accountant assessment of each occurred transaction (Din *et al.,* 2017). The

lack of guidance in the IFRS application will confuse accounting subjects in countries with a high level of power distance since they have been accustomed with instructions and clear guidelines.

H1: Power distance has a negative influence on IFRS adoption level.

2.10 Individualism and IFRS Adaption Level

Collectivism is defined as how an individual sees himself as an integrated part of a community. By contrast, individualism is able to be defined that, in a community, the members act in self-judgment and are responsible only to themselves. Schuler and Rogovsky (1988) find that individualism is positively associated with the use of performance-based contract payment. In countries with a high individualism level, management is likely to make a more favorable accounting decision, causing high-income discretionary (Han *et al.,* 2013). To minimize earnings management, accounting practices should be regulated comprehensively. Therefore, the principles-based IFRS adoption is less favored.

H2: Individualism has a negative influence on the IFRS adoption level.

2.11 Masculinity and IFRS Adoption Level

Masculinity indicates an individual preference for achievement, aggressiveness, and material success (Nabar and Thai, 2007). Hofstede (2001) divides cultural groups into two based on masculinity and femininity. A community with masculinity will be firm, resilient, and focused on achieving material. Meanwhile, a community with femininity will be fashionable, gentle, and focused on life quality. This shows that cultural difference might lead to the different orientation in performance achievement. Hastings (1981) in Nabar and Thai (2007) states that masculinity is positively associated with social acceptance towards aggressive behavior. A high aggressiveness level in the community with masculinity will refuse the concept of conservative accounting. The community with masculinity prefers the use of fair value in accounting measurement. Although this measurement is less reliable, it is considered more relevant in decision-making. Therefore, the IFRS application will be preferred over conventional accounting standards.

H3: Masculinity positively influences IFRS adoption level.

2.12 Uncertainty Avoidance dan IFRS Adoption Level

DiRienzo *et al.* (2007) states that, in an environment with high uncertainty avoidance, the organization members will feel uncomfortable with the uncertainty causing them to be reluctant in opposing the authority. Moreover, the high uncertainty level is likely to encourage individuals to corrupt (Siallagan *et al.,* 2017; Munawarah *et al.,* 2017). Gray (1988) states that uncertain situation will encourage

accounting measurement to be more conservative. This is not in accordance with IFRS concept that is likely to disregard the conservative concept and replace it with the prudence concept.

H4*: Uncertainty avoidance negatively influences IFRS adoption level.*

2.13 Law Enforcement and IFRS Adoption

In the study of the influence of law enforcement on the financial information quality represented by judicial system efficiency, rule of law, corruption, risk of confiscation, contract denial by the government and accounting standards, La Porta *et al.* (1998) find that law affects the quality of generated accounting information. Leuz *et al.* (2003) find a negative correlation of law enforcement and the investor rights with earnings management. Law enforcement provides a guarantee for the investors regarding the corporate governance transparency. In a country with strict law enforcement, financial information more relevant for the investors is expected, and management opportunistic behavior is able to be minimized. Therefore, the IFRS implementation will provide more value to the investors.

H5*: Law enforcement has a positive influence on IFRS adoption level.*

3. Methodology

The population in this study was all countries in the world. The sample was selected using purposive sampling method with certain criteria. The criteria used were first, the countries had and would be fully or partially implementing IFRS, second, the countries used as the subjects by Hofstede (2001), and third, the members of the World Economic Forum in 2014.

The data used in this study were secondary data from various sources. The data contained the cultural characteristics, including power distance, uncertainty avoidance, individualism and collectivism, masculinity and femininity, and long versus short-term orientation (Hofstede, 2001). In addition, the data included the legal right index from the survey of the World Economic Forum in 2014, and the IFRS adopter profile in 2014 from IFRS Foundation.

Uncertainty avoidance refers to a cultural characteristic in which the followers of the culture are likely to feel uncomfortable or comfortable in an uncertain situation. The power distance level in a country was also used in this study (Hofstede, 2001). Power distance is the imbalance degree in authorities between individuals with lower authority and individuals with higher authority. Individualism is the opposite side of collectivism on how the individual sees himself as an integrated part of a community. Masculinity is the cultural condition reflecting a firm and sturdy attitude, and focused on achieving material.

In addition, the variable of law enforcement was used in this study. Law enforcement was measured based on the legal rights index based on the survey of the World Economic Forum in 2013. The legal rights are made by a national or international organization recorded in the form of laws, government regulations or other, containing a rule regarding the protection and limitation of the individual rights in order not to clash with other rights. In other words, the right bound by a law, if it is violated or obeyed, will lead to legal consequences.

The measurement of the IFRS adoption level by countries based on the jurisdiction profile of IFRS adopters as published by IFRS Foundation is developed in this study. IFRS adoption level was measured by giving a score on each indicator, 1 if it meets the defined indicator, 0 if it does not. The indicators included the government made a commitment to adopt IFRS as the accounting standards in the country; the accounting standards being used was in accordance or converged with IFRS; the country was using IFRS (not the result of convergence) as the accounting standards; the country allowed the use of IFRS on companies in the capital market; the country adopted IFRS for small and medium-sized business entities.

3.1 Hypothesis Testing Model

To test the hypothesis in this study, multivariate statistical regression analysis was used with the following equation:

$$IFRS = \alpha + \beta 1 \, UAVD + \beta 2 \, PDIS + \beta 3 \, IDIV + \beta 4 \, MASC + \beta 5 \, LTOR + \beta 6 \, LRI + \varepsilon$$

in which:
IFRS : IFRS adoption level divided by the maximum value of the sample;
UAVD : Uncertainty avoidance score (Hofstade, 2001) divided by the maximum value of the sample;
PDIS : Power distance (Hofstade, 2001) divided by the maximum value of the sample;
IDIV : Individualism (Hofstade, 2001) divided by the maximum value of the sample;
MASC : Masculinity (Hofstade, 2001) divided by the maximum value of the sample;
LRI : Legal rights index (Hofstade, 2001) divided by the maximum value of the sample.

4. Results

4.1 Descriptive Statistics

In this study, one dependent variable and five independent variables were used. To determine the value of each variable and its distribution, a descriptive statistical analysis was performed.

Table 1. *Descriptive Statistics.*

Variable	Observation	Mean	Median	Max	Min	Std. Dev
PDIS	58	0.562	0.577	1.000	0.106	0.213
UAVD	58	0.601	0.625	1.000	0.071	0.215
IDIV	58	0.481	0.433	1.000	0.067	0.268
MASC	58	0.463	0.455	1.000	0.045	0.177
LRI	58	0.570	0.611	1.000	0.100	0.237
IFRS	58	0.767	0.800	1.000	0.200	0.256

Table 1 shows that in this study 58 countries are observed. The country with the highest power distance level was Malaysia with the score of 104 and that with the lowest was Austria with the score of 11. The country with the highest uncertainty avoidance was Greece with the score of 112 and that with the lowest was Singapore with the score of 8. The country with the highest individualism was the United States with the score of 91 and that with the lowest was Ecuador with the score of 8. The country with the highest masculinity level was Japan with the score of 91 and that with the lowest was Sweden with the score 5. Finally, the country with the highest legal rights index was Hong Kong with the score of 10, and that with the lowest was Venezuela with the score of 2.56.

4.2 Hypothesis Testing Results

The study used multiple regression analysis. T-test was performed to test the partial regression coefficient for the hypothesis 1-5 with a significance level of 95%. In this study, all classical assumption testing had been conducted and the result was that the research model was free from multicollinearity, while autocorrelation, heteroscedasticity and residual were normally distributed.

Table 2. *Hypothesis Testing Results.*

IFRS = α + β_1 UAVD + β_2 PDIS + β_3 IDIV + β_4 MASC + β_5 LTOR + β_6 LRI + ε				
Variable	Predict	Coefficients	t	p value

	Sign			
Constant		0.679	3.834	0.000
PDIS	-	-0.288	-2.052	0.045**
IDIV	-	0.000	1.225	0.997
MASC	+	-0.075	0.004	0.581
UAVD	-	0.149	-0.555	0.226
LRI	+	0.387	2.820	0.007***
***) Significant 1 %				
**) Significant 5%		Observation (n)		58
F-Statistic	9.663	R Square		0.298
p value	0.000	Adj. R Square		0.269

Based on the results of multiple regression analysis, the influence of power distance on the IFRS adoption level has a coefficient value = -0.288, t = -2.052, significant at 5% level. Therefore, the first hypothesis, stating that power distance has a negative influence on the IFRS adoption level, was supported. Countries with a high level of power distance are likely to consider instruction from the higher hierarchy as a rule that should be applied. In this concept, the roles of decision makers and implementers have clear limitations. Chan *et al.* (2003) explains that in countries with high power distance, the absence of instructions from the management leads to greater possibilities of accounting errors.

Accounting standards based on rules set by the Financial Accounting Standards Board (FASB) are previously and frequently used as a reference to accounting standards in various countries. On the other hand, IFRS formulated by the IASB is structured as accounting standards based on the principle, causing the detailed instructions is very less since the standard application requires professional accountant assessment of each occurred transaction. The lack of guidance in the IFRS application will confuse accounting subjects in countries with a high power distance level since they have been accustomed with instructions and clear guidelines.

Based on the regression analysis, the influence of cultural factors, including individualism, masculinity, uncertainty avoidance and IFRS adoption level, had a significant value greater than 5%, meaning that the results were statistically insignificant. Therefore, hypothesis 2, 3, and 4 were not supported. The results indicated that individualism, masculinity, uncertainty avoidance had no influence on the IFRS adoption level. This was possibly caused by different cultures followed by the community members and the decision makers. Although the community members follow individualism, masculinity, and uncertainty avoidance, the decision makers might not follow the same culture. In the case of international accounting standards or IFRS application, the decision favors universal rules of general community. The IFRS application as the international accounting standards is

supported by several global organizations such as the G20, the World Bank, IMF, the Basel Committee, IOSCO, and IFAC. Therefore, the IFRS application of a country is influenced by the involvement of the country in the global organization obliging IFRS application.

The result of hypothesis testing showed that the influence of legal rights index on IFRS adoption was statistically significant with t value = 2.820 and at 1% error rate, meaning that the legal rights index had a positive influence on IFRS adoption. This meant that hypothesis 5 was supported.

The results are consistent with Renders and Gaeremynck (2007), stating that countries with a strong law enforcement   prefer IFRS adoption as it is able to minimize the asymmetrical information between management and investors. Law enforcement will provide a guarantee for the investors regarding the transparency of corporate governance. In a country with a strict law enforcement, financial information more relevant for the investors is expected and managerial opportunistic behavior is able to be minimized. Therefore, the IFRS implementation will provide more value to investors.

5. Conclusion

The findings indicate that the power distance level of a country negatively influences the tendency of the country to adopt IFRS. In countries with a high power distance level, IFRS application leads to the confusion in accounting practices due to the lack of detailed guidance in a principle-based standard. On the other hand, individualism, masculinity, uncertainty avoidance have no influence on the propensity to adopt IFRS. This is possibly caused by the mandate of IFRS application for the countries as a part of a global organization such as the G20, the World Bank, the IMF, the Basel Committee, IOSCO, and IFAC. A strong law enforcement has a positive influence on the tendency of the country to adopt IFRS since it is able to minimize the asymmetrical information between management and investors.

However, this study has a limitation. The cultural dimension size used is the survey by Hofstede (2001), in which it is less relevant with the current cultural condition, caused by the rapid development of technology and cultural acculturation. Therefore, future studies should develop the cultural dimensions of a country that is more relevant to the current conditions. In addition,   future studies should examine and develop the IFRS adoption level to create a more accurate depiction of the IFRS adoption level.

An earlier draft of this paper, titled "Peran Budaya dan Penegakan Hukum dalam Menentukan Tingkat Pengadopsian IFRS," was presented at the 18th Simposium Nasional Akuntansi, September 16-19 2015, Medan, North Sumatera, Indonesia. We would like to thank to all participants and reviewers to their valuable comments.

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