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## **Comparability and Reliability of Financial Information in the Sector of Czech SMES (ten years of IFRS as a part of Czech accounting context)**

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**Abstract:**

*The aim of this article is to analyse the form and extent of IFRS adoption in the Czech accounting and the main reasons of the lack of interest in IFRS reporting with a special attention to the segment of SMEs. This research is based on the qualitative analysis of present accounting regulation and on results of questionnaire survey of 260 Czech SMEs. As the main causes of the lack of interest in IFRS usage are the specific features of economic conditions, resulting in imbalances between the costs and benefits of practical implementation of IFRS and the lack of interest to report in accordance with IFRS on the side of business partners.*

**Key words:** *IFRS, Effect of IFRS Adoption, Accounting Harmonization, Small and Medium Enterprises*

**JEL Classification:** *M41, P20*

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## 1. Introduction

Since 2005 the firms listed on the regulated capital markets in the EU are required to prepare their financial statements in accordance with the IFRS. The main intent of IFRS adoption were (1) to ensure greater comparability and transparency of financial reporting, (2) to reduce information asymmetry and (3) to improve the quality of information for users of accounting information. On the macroeconomic level there were expectations of increase of the volume of trading on capital markets, boost of foreign direct investments and intensification of the international exchange of goods and services. Mandatory IFRS adoption resulted in changes affecting broader pool of companies, not only those that have a direct obligation to use IFRS, but it influenced the entire accounting system in many countries around the world (Heil *et al.*, 2009; Daske *et al.*, 2008; Leuz, & Wysocki, 2008).

The Czech economy is an open economy, dependent, to a large extent, on exports of goods and services. It belongs to a group of transitioning economies that transformed from a centrally planned to a market economy and it has created new accounting regulations fitting the new conditions. The transformation of the accounting system was performed at the same time as the transformation of the whole economy which was an important part of this process.

Generally, the process of accounting harmonization resulted in the mandatory adoption of IFRS for preparation of Financial Statements on EU capital markets. IFRS became a tool, which supported the new concept of financial reporting. Despite of positive predictions, the implementation of IFRS into Czech the accounting system has been very low and slow. The causes of this delayed implementation can be seen on many levels.

The aim of this article is to analyse the form and extent of IFRS implementation to the Czech accounting system and the main reasons of the lack of interest in IFRS adoption with a special attention to the segment of Czech SMEs. This analysis is based on two methods (1) qualitative assessment of present accounting legislation and (2) on the results of questionnaire survey of a set of 260 Czech companies including majority of SMEs.

## 2. Literature review

### 2.1. IFRS adoption effects in various national conditions

The ten years during which the companies were obliged to compile accounting statements in accordance with the IFRS enabled researchers to assemble sufficient amount evidence and experience of the use of IFRS in national conditions to enable subsequent analysis that can become a source of improvement of IFRS rules. It can also serve as a source for improvement of accounting regulations and enable coordination of IFRS adoption in different national contexts. The accounting harmonization was aimed to decrease the differences in accounting information

stemming from different national economic backgrounds. More accurately, it aimed to set the boundaries to the degree of variations in accounting rules and procedures (Zarova et al., 2014). Furthermore, in transitional economies, the harmonization in stock and capital markets was an opportunity that enabled them to reconstruct their accounting system in such a way that it could comply with conditions of market economy (Thalassinos, Maditinos & Paschalidis, 2012). The majority of extant studies relieved that the value relevance of accounting data and comparability of financial reporting is enhanced following the adoption of the IFRS. However, mixed evidence exists regarding the effects of IFRS adoption on earnings management, timely loss recognition, costs of equity and other aspects of accounting quality, e. g. (Tsalavoutas, & Dionysiou, 2014; Alsaqqa, & Sawan, 2013; André, Filip, & Paugam, 2015; Cordazzo, 2013, Liapis *et al.* 2013).

Many studies point out, that international accounting standards cannot fulfil the goal of harmonization on their own. That only acceptance of IFRS, which respects the particular national, economic, legal and cultural background will show to which degree were the goals of harmonization fulfilled (Nobes, & Parker, 2012; Beneish *et al.*, 2012). On the other hand, some research implies that international financial reporting standards have lost their general transnational character and have adopted specific national features of specific national environments in which they have been used (Nobes, & Parker, 2012). In EU countries the IFRS is mandatory for companies listed on capital markets. In these countries, greater comparability of financial data at the international level is a trade-off for reduced comparability inside the national economies (Brüggemann *et al.*, 2013).

The number of countries that use the IFRS continues to grow. The full implementation of IFRS is the most frequent in less developed countries. There the use of IFRS is mandatory for all entities, not only for listed companies. The reason is that their own national accounting standards have not developed sufficiently in these economies, and when these countries do not have their own accounting standards they usually accept IFRSs in full. In these countries, therefore, the implementation of IFRS brings a significantly different effect than in countries with developed financial and economic systems (Alsaqqa, & Sawan, 2013; Efobi *et al.*, 2011; Kamath, & Desai, 2014).

Up to now, national accounting has developed as a part of the national economic system within which it functioned under the influence of number of local factors. The most important features were (1) the prevailing legal system, (2) system of redistribution of financial resources and (3) relation of national accounting to the tax system (Nobes, & Parker, 2012; Belkoui, 2006). Although the general purpose of financial statements is similar in most countries, the national accounting systems and financial information revealing the company's situation and performance differ. A specific national accounting system is therefore unique, incomparable and not fully compatible with other national accounting systems. The adoption of unified standards for financial reporting (IFRS) should ensure greater comparability and

transparency of financial reporting. It should also improve the accounting information quality, reduce information asymmetry between the owners and managers and create friendly and transparent information environment for investors (Thorell, & Whittington, 1994). The effects of IFRS adoption should lead to the increase of the cross-border capital flows, encouragement the firms' cooperation in foreign trade and other international cooperation.

In the Czech Republic the system of accounting and its regulation was at all times under the dominant influence of Roman law (code law), in the condition of strong position of banks in the process of capital redistribution and in close relation to the tax system. After the changes in 1989, major reform of accounting through the Accounting Act came into effect on January 1<sup>st</sup> 1992. This act represented quite a radical change of previous accounting system. However, even here the on-going strong influence of the state impacted on new accounting regulation. There still dominates a tendency of quite detailed regulation of reporting (both financial statements and the process of bookkeeping) for various types of business organizations. This law was subsequently modified several times due to the changing economic and political climate and also with regard to the development of accounting theory and practice starting from 2005, when the Czech Republic become a member of the EU, under the regulations of the EU.

## 2.2 The extent of IFRS implementation in the Czech accounting system

The degree of implementation of IAS/IFRS in the Czech national accounting system can be measured from the point of view of which entities are obliged to use the IAS/IFRS system for preparation of their financial statements and at what capacity - obligatory vs. voluntary. Another perspective could be, (1) whether the IFRS principles became a part of Czech national standards (CAS), (2) which types of companies use IFRS as a mandatory system (in accordance with the EU Regulation 1606/ 2002), and (3) which companies use the IFRS voluntarily upon their own decision. These features are summed up in table 1.

**Table 1:** IFRS in the financial reporting system of the Czech Republic

Usage of IFRS				IFRS		CAS	
				mandatory	voluntary	mandatory	
<b>Individual entities (individual statements):</b>							
<b>Independent entities</b>	- issuers of securities trading on EU capital markets	- actually trading on EU capital markets		<b>x</b>		<b>x</b>	
		- former trading on EU capital markets	- intend to be trading in the next 3(4) years			<b>x</b>	<b>x</b>
			- don't intend to be trading			<b>(x)</b>	<b>x</b>

	- <b>non-issuers</b> of securities trading on EU capital markets	- applying to be admitted to public trading	<b>x</b>		<b>x</b>
		- non applying to be admitted to public trading		<b>(x)</b>	<b>x</b>
<b>Subsidiary</b>	Entities-subsiary of a group of companies which apply IFRS for its consolidated financial statements		<b>x</b>		<b>x</b>
	Entities-subsiary of a companies, which don't apply IFRS for its consolidated statements			<b>(x)</b>	<b>x</b>
<b>Group of companies (consolidated statements)</b>					
- <b>issuers</b> of securities trading on EU capital market	- actually trading on EU capital market		<b>x</b>		<b>x</b>
	- former issuer which intend to continue within the next 3(4) years			<b>x</b>	<b>x</b>
	- former issuer which don't intend to continue			<b>(x)</b>	<b>x</b>
- <b>not issuers</b> of securities trading on EU capital market	- applying to be admitted			<b>(x)</b>	<b>x</b>
	- not intend to be admitted			<b>(x)</b>	<b>x</b>
<b>Banks</b> and other financial institutions <sup>1)</sup>			CAS for financial institution (are fully in compliance with IFRS)		

Source: own elaboration

Notes: (x) - IFRS is permitted but not mandatory

## 2. Data and Method

The aim of our research study is to ascertain the current state of IFRS adoption in present practice of Czech companies. The main research method is the technique of questionnaire survey. The analysis was conducted using an online questionnaire in March and April of 2015. The questionnaire was developed on the basis of two previous studies conducted with the same aim three and five years ago with the primary focus on Czech SMEs (Mullerova *et al.*, 2010; Pasekova, 2012). The sample of previous research was broadened to all types of enterprises without limitation. A database containing e-mail contacts to chief financial officers and chief accountants of 1,613 Czech medium and large firms was used. In total we have processed 258 completed questionnaires; this implies a response rate of 15.99 per cent. The structure of respondents according to size and industry is presented in Table 3.

**Table 2:** Sample characteristics

Company	Number of respondents	Industrial sector				
		Manufacturing	Trade	Services	Construction	Agriculture/Other
Micro	6	0	1	4	1	0
Small	37	8	15	11	3	0
Medium	138	73	20	23	13	9
Big	77	49	6	18	4	0
<b>Total</b>	<b>258</b>	<b>130</b>	<b>42</b>	<b>56</b>	<b>21</b>	<b>9</b>

*Source: own research*

All together there were 181 companies which belong to the category of SME(70 per cent) and 77 firms (30 per cent) which were identified as large companies or their subsidiaries. The questionnaire consisted of five parts: the first part was aimed at identification of the respondent. The second part investigated the potential reasons for IFRS adoption, i.e. cooperation with foreign partners (parents, suppliers, customers). In this part we investigated the intention to establish the foreign contacts, which could be a potential stimulus for the usage of IFRS. The third part was aimed at investigation of the degree of involvement of IFRS in the SMEs own accounting practice (how are the accounts kept). The fourth part investigated the most time consuming accounting issues), and the fifth part investigated the experiences of the IFRS usage.

Qualitative analysis, comparison, elementary quantitative characteristics and correlation were used for processing the collected results. Subsequent cluster analysis was used for visualization of the causes of IFRS employment.

The questions in the main part focused on the state of IFRS adoption. We have examined whether companies report under any other standards than Czech accounting standards. The results showed that there were 89 firms, i.e. 34 per cent of companies which prepared financial statements in accordance with CAS and other standards concurrently. These companies mostly used the IFRS (70 firms, i.e. 28 per cent), and a small percentage of firms (6 per cent) used the USGAAP or German or French standards. As the main reason for the use of IFRS was a requirement of their parent company. This was reported in 62 cases (90 per cent of the sample), while other reasons, such as comparability of data and access to the bond issuance were quoted by only one or two respondents. As to the method of preparation of financial statements in accordance with IFRS the firms reported most often the so-called “transformation bridge” (47 per cent of companies). This indicated that the firms did not use the IFRS to track their transactions, but they “transformed” their Czech

financial statements to IFRS statements. Preparing two separate sets of accounting books was used by 19 firms, i.e. 27 per cent of companies of the sample, and 10 firms (14 per cent of firms) reported only selected items in accordance with IFRS. Most of firms that used the IFRS were from the sectors of services, trade and manufacturing -for more details see Table 4.

**Table 3:** Sample characteristics, the accounting standards usage and accounting practice

<b>Sample characteristics</b>					
<b>Accounting standards used besides CAS</b>		<b>IAS/IFRS</b>	<b>US GAAP</b>	<b>Other</b>	<b>None</b>
		<b>% (abs.)</b>	<b>% (abs.)</b>	<b>% (abs.)</b>	<b>% (abs.)</b>
		27 (70)	4 (10)	3 (9)	66 (169)
<b>Company location (in %)</b>					
	Small city in CR	27,1	3,9	3,5	65,5
	Regional city in CR	22,5	2,8	3,5	71,1
	Prague	24,6	1,6	3,3	70,5
	Foreign country	50	50	-	-
<b>Business sector (in %)</b>					
	Manufacturing	27,7	5,4	5,4	61,5
	Trade	28,6	4,8	2,4	64,3
	Services	33,9	-	1,8	64,3
	Construction	9,5	4,8	-	85,7
	Agriculture	14,3	-	-	85,7
<b>Practice of accounting</b>					
Accounting kept by:	Own employees	Accounting firm		Individual accountant	
	92% (238)	6% (16)*		2% (4)	
<b>Creation of financial statements:</b>					
	Translation bridge from CAS accounting	48	40	67	-
	Two independent accounting books	28	20	11	-
	Translation of selected items only	14	20	11	-
	Different way	10	20	11	-

Source: own research

Note: value in brackets represents number of answers

\* Just five operating accounting firms offer preparation in IAS/IFRS;

In the subsequent part of the questionnaire were investigated the foreign contacts of the firms as the potential reason of the IFRS use. The results showed that more than a half of the companies (63 per cent) have business contacts abroad. The foreign contacts were established mainly with important suppliers, followed by links to the parent companies and to major customers. The results show that the nature of international contacts almost always represent the commercial interests of the company rather than a possibility of access to financial sources on foreign capital markets. This is in line with the character of the Czech economy with a large export segment. The same part also investigated the intentions to expand contacts with foreign countries. These intentions were understood as potential incentives for the use of IFRS. The results showed that the firms are not considering expansion into foreign markets (72 per cent). Moreover, only a small percentage of firms are interested in entering the capital market (0.4 per cent – one firm). These facts confirm the great impact of the ownership structure of Czech firms: they are mostly a subsidiary and operate abroad only through their parents companies. These firms already use the IFRS, i.e. that they or their parent companies are issuers of securities. It can be considered as one of the main causes of slow increase of IFRS adoption in the Czech economy. And this aspect again reflects only a limited role of Czech capital market in local economic system.

In the same part we have also investigated the awareness of IFRS through completion of IFRS training by firm employees. It has been found that 90 companies, i.e. 35 per cent, have some awareness of the existence of IFRS. However, 168 respondents (65 per cent) confirm only basic knowledge (120) or have no information (48), i.e. 47 and 18 per cent respectively. Interest in attending IFRS training was identified in 35 companies (13 per cent). Therefore it seems that the awareness of company management or accounting department is relatively high, even if the firms do not currently report under IFRS. On the other hand, there are firms that have little or no information and have no interest in the IFRS (61 per cent, and 12 per cent from the whole sample). More details are in table 5.

**Table 4:** Potential incentives to IFRS adoption

Potential reasons of IFRS adoption		IAS/IFRS (%)	US GAAP (%)	Other (%)	None (%)
Intention to contact foreign customers					
	- Yes	28,1	4,9	4,3	62,7
	- No	24,6	1,4	1,4	72,6
Intention to contact foreign suppliers					
	- Yes	27,4	4,7	4,2	63,7
	- No	26,1	-	-	73,9

	Another form of entry on the foreign market (to issue securities)				
	- Yes	62,5%	0%	0%	37,8 %
	- No	26,0%	4,0%	3,6%	66,4%

*Source: own research*

The next part of the questionnaire investigated the views and expectations and evaluation of IFRS. It is surprising that 95 of the respondents from IFRS non-adopters, i.e. 66 per cent and 38 per cent of the sample, did not see any benefits in reporting according to IFRS despite the fact that they have contact with foreign customers or suppliers or intend to establish such contact. This was confirmed by 108 and 129 respondents in the sample respectively (i.e. 41 and 50 per cent). It confirmed that there was only a very low or no correlation between the IFRS use and existence of the foreign contacts. Thus it can be concluded that firms still do not associate cooperation with a foreign partner with IFRS reporting. This also implies the conclusion that foreign markets still do not require transparent and comparable information as a useful tool of foreign cooperation.

The last part of the questionnaire investigated the perceived benefits of IFRS adoption. In total, 169 (or 66 per cent) answered that they did not use the IFRS. This interesting revelation on the use of IFRS raises a question: what advantages or benefits are perceived by respondents in connection with the use of IFRS (answered companies that still do not use the IFRS). Only five per cent of IFRS non-adopters consider the adoption of IFRS in the future. And only 14 per cent of respondents perceive some benefits of using IFRS, while 86 per cent see no positive effects of the use of IFRS. From eight enlisted benefits of the IFRS usage the respondents most frequently have chosen the reason: “Better comparison of accounting data” (69 per cent) and: “Easier reporting” (66 per cent).

Knowledge of potential benefits reflects an awareness of IFRS at least at a general level (86 per cent). The second most frequently quoted benefit was “Higher credibility for business partners” (47 per cent). Interesting findings follow from the response that 28 and 22 per cent of respondents connect IFRS reporting with better use of internal data for in-house managerial accounting and internal reporting respectively. This aspect has been already discussed by (Prochazka, 2014; Zarova et al., 2014). A very low number of respondents perceived the importance of IFRS for easier access to bank loans (3 per cent). This can be understood as a reflection of the basic designation of the IFRS, but it is also a reflection of the fact that banks do not require IFRS as reliable statements of financial position. For more details see table 6.

**Table 5:** Characteristics of IFRS non-adopters

<b>Non-adopters ( 169 companies)</b>					
Will you consider IFRS adoption?			Are there any benefits from IFRS adoption for your company?		
- Yes	4%		- Yes	14%	
- No	96 %		- No	86 %	
<b>Main reasons for not adopting IFRS</b>			<b>What benefits of IFRS adoption?</b>		<b>%</b>
No benefits for company	3 8		Better comparison of accounting data	69	
Don't know about benefits of IFRS usage	2 9		Easier reporting	66	
Company is not issuer of securities	1 4		Higher credibility for business partners	47	
Other	1 1		Better public perception	28	
Don't have a foreign business partner	9		Better usage of data for business management	28	
			Better quality of inter-company information	22	
			Better access to EU funding	13	
			Getting loans easier	3	

Source: own research

The adopters of IFRS were asked about difficulties and benefits linked to the IFRS adoption. Regarding additional costs associated with transition to IFRS, they most frequently reported costs in the range of 5 per cent of firm turnover (31 per cent of respondents). The most frequently reported costs were the cost of training (67 per cent), consulting services (51 per cent) and IT adjustments (43 per cent). Meanwhile, the main positive effects of IFRS adoption perceived by IFRS adopters were: "Getting loans easier", "Easier increase of equity capital", "Easier issuance of bonds" and "Better access to EU funding". See Table 7.

**Table 6:** Characteristics of IFRS adopters

<b>IFRS Adopters (70 companies)</b>					
<b>Costs of implementation IFRS</b> [% of business turnover]	< 0,05	0,05 – 0,5	0,5 – 1	> 1	Couldn't estimate
	31%	12%	1%	1%	54%
Types of costs (in % of costs)	<b>Consultancy</b>	<b>IT</b>	<b>Training</b>	<b>Salary</b>	<b>Other</b>

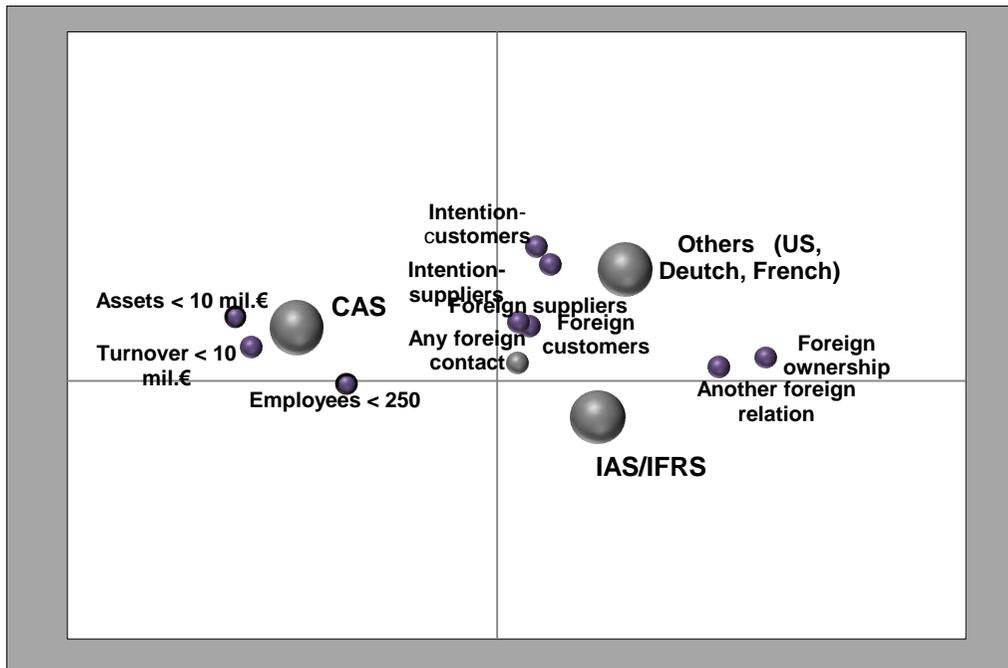
	Preparation of IFRS statements	51	43	67	20	6
	Implementation of other standards	33	29	20	13	6
<b>Views on IFRS adoption</b>						
<b>Problems</b>		%		<b>Benefits</b>		*
CAS is subordinate to tax reporting		3 6		Easier reporting		1,6
Complicated terms under IAS/IFRS		2 5		Better comparison of accounting data		2,1
Different problem		1 6		Better quality of internal information		2,7
Big difference between CAS and IFRS		1 0		Better usage of data for business management		2,7
Insufficient instruction for first adoption		6		Higher credibility for business partners		2,9
Difficult translation		4		Better public perception		2,9
Nonexistence of some transactions used in IFRS		3		Getting loans easier		3,4
Insufficiently developed capital market		0		Easier increase of equity capital		3,4
Investors and users do not require IFRS		0		Easier issuance of bonds		3,6
				Better access to EU funding		3,4

*Source: own research*

*\*Note: average mark from 68 companies on a scale from 1 (means yes) to 5 (means no)*

**Cluster analysis of questionnaire results:** Our findings were visually confirmed by cluster analysis. As can be seen on the Figure 1, the Czech Accounting Standards (CAS) are very close to the criteria for SMEs, i.e. CAS are used mainly by firms belonging to the SMEs category which have only limited contact with foreign business partners and do not intend to establish these contacts. Cooperation with foreign partners or intention to establish such cooperation is close to the other accounting standards. These were represented by German and French standards and also to limited extent by the US standards.

This layout clearly reflects the orientation of Czech foreign trade and form of international cooperation of Czech companies. On the other side the use of IFRS is relatively isolated from other categories. It also represents the real state in the Czech economy and companies, because the IFRS adoption is predominantly a matter of parent companies. Also the relation of the IFRS and the other accounting standards to foreign ownership of firms confirms the structure of dominant foreign trade orientation. On the other hand there are no significant relations to the capital market and financial funds.



**Figure 1:** Cluster analysis of the questionnaire results

*Source: own research*

#### 4. Results, Discussion and Conclusion

To sum up, the findings of our research were more or less in line with expectations and in accordance with specifics of the Czech economy. The use of IFRS is still relatively rare, even though it has increased in comparison to previous studies from 2010 and 2013 (from 16 per cent to 28 per cent of the companies surveyed). The most often quoted reason of the IFRS usage is the requirement to IFRS use by parents companies. On the contrary an important reason for not reporting in accordance with IFRS is the perceived absence of any benefits for surveyed companies. This fact can be considered as a result of weak position of capital markets in the Czech economy and ownership structure of Czech companies (58 per cent of the firms are now under control of foreign owners). Most of all companies (92 per cent) prepare their financial statements internally (the offer to prepare statements in accordance with IFRS by professional accounting firms is negligible). The most often used method of preparation is predominantly the translation bridge. There are some differences between the IFRS adopters and non-adopters with regards to perceived benefits of the use of IFRS, but the most significant reasons are similar for both groups, i.e. easier reporting within the group, increased credibility and a better perception of the company.

To conclude, the real use of IFRS is very low outside the mandatory group of Czech companies, which include only a few big firms and banks. The interest in voluntary adoption of IFRS for financial statements comes only from the purposes of consolidation with foreign company. The reason of these results can be finding in many aspects of the Czech economy: treatment of the accounting regulations, historical and cultural specifics, weak capital markets, and the change of traditional predominantly industrial structure of the economy, which came under the control of foreign owners due to the ownership changes following the Velvet revolution in 1989. And last, but not least important reason is a lack of trust in the accounting system (which is further weakened by subordination of accounting to tax reporting). There are also significant, substantial differences between the IFRS and Czech accounting rules and regulations and perceived additional expenses of the transition process to IFRS reporting for those companies that want to adopt them contrasting to low perceived benefits. Our findings were also confirmed by visualization using cluster analysis.

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### **Notes:**

<sup>1)</sup> Banks and other financial institutions form a special category. Accounting in the financial sector has changed substantially. According to current accounting practice, banks and some financial institutions (i. e. regulated financial institutions except insurance companies) have to report their financial position in accordance with IFRS rules from January 1<sup>st</sup> 2002. Mandatory reporting for the vast majority Czech banking sector started on January 1, 2005. Czech accounting standards for this sector are thus fully harmonized and in compliance with the principles of IFRS. In other, non-financial sectors, only selected areas are harmonized with IFRS. These concern in particular financial instruments.

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