Impact of International Harmonization on Czech Accounting Legislature (Focused on Mergers)

Jiří Strouhal, Carmen Bonaci, and Roman Sklenár

Abstract**—**Use of harmonized accounting standards may reduce investor's uncertainty and can thus reduce the cost of capital. It can significantly improve the communication between business users and all their statements. Due to the globalization of business and international harmonization of financial reporting Czech Republic experiences a shift in paradigms from historical costs accounting towards fair value measurement. Paper provides an analysis between national accounting legislature and international referential. There is also provided how the ability to measure accounting harmonization can be helpful from the perspective of a globalized world. A comparative analysis between Czech accounting regulation and IFRS or IFRS for SMEs show the level of compatibility between these three sets of accounting regulation.

Keywords**—**International harmonization, globalization, IFRS, econometric tools, Czech Republic, mergers.

I. Introduction

SMEs sector forms as much as 99 % of business entities around the world. They have fewer resources to use on influencing financial standards and the system is arguably less responsive to their needs. The tightening of professional accounting standards and the proliferation of extensive and complex accounting pronouncements governing financial reporting have added complexities to the preparation of financial statements and have further exacerbated their financial reporting problem. The need to establish appropriate accounting standards for SMEs is one which invariably draws common agreement but generally, there is no consensus achieved on the recommended solutions. The biggest obstacle is existence of 27 different systems of accounting within the European Union, which have to be harmonized. The question about whether or not accounting standards should apply equally to large and small companies has been the subject of much debate and concern by accountancy bodies in many countries [16] and has become known as the "Big GAAP/Little GAAP" debate [8].

Size is an important determinant for accounting differentiation. The empirical research studies leaving still a considerable gap of ignorance about the influence of an entity's size on the attitudes of its representative and its stakeholders with regard to financial reporting. Some studies have concentrated on the particularities of SMEs with regard to the objectives, purposes and users of financial statements of SMEs. Those are, e.g. [1, 3, 6, 9, 19, 22]. Other studies focused on the attitudes and behavior of SMEs with regard to financial statements' publication and audit [10].

However, the arguments for differential reporting seem to be stronger the important argument now appears to be, not whether this is an appropriate approach but rather how accounting standards for large entities and SMEs should differ [11, 17]. It must be decided what criteria will be used for distinguishing different classes of reporting entities and these should reflect cost/benefit considerations [11].

Specific accounting standards created for a category of enterprises that is so difficult and subjective to define and identify might be ineffective, difficult to interpret and also, difficult to regulate and to maintain [12].

One the main arguments for extending IFRS implementation to SMEs' accounts is that global financial reporting standard (if applied consistently) will enhance international comparability and understandability [18], as well as, the transparency and accountability of SMEs accounting reports [12]. Greater information relevance, which is also beneficial for management and market efficiency are other suggested benefits for SMEs by the extension of IFRS [12].

There is some evidence that suggests the difficulties or the failure of the adoption process: the lack of political will, rooted in local culture and a strong national outlook prevented a truly harmonized framework, a magnitude of the differences that exist between countries and the high costs to eliminate them [14]; local traditions exercise a strong influence over the implementations of new concepts (as previously noted on true and fair view) [29]; tax and legally-based orientation hinder the harmonization process [15, 34]; diversity will not disappear as it comes from different accounting cultures and their interpretation will be partly influenced by their history and previous practice [2, 13, 23, 24, 25, 33].

Several questions arise in this context: are transition countries, while their accounting models have understandably less tradition, more at ease to implement full IFRSs and the IFRS for SMEs? Are the differences between local practices and IFRSs more easily to be reduced? Previous studies show that even if some changes towards Substance over Form and a focus on investors have been tempted, the emphasis on compiling proper accounting records and on adhering to tax

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J. Strouhal is with the University of Economics Prague, W. Churchill Square 4, 130 67 Prague 3, Czech Republic (e-mail: strouhal@ vse.cz).

C. Bonaci is with Babes-Bolyai University Cluj Napoca, T. Mihali 58-60, 400592 Cluj Napoca, Romania (e-mail: carmen.bonaci@econ.ubbcluj.ro).

R. Sklenár is with the University of Economics Prague, W. Churchill Square 4, 130 67 Prague 3, Czech Republic (e-mail: xsklr02@ vse.cz).

regulations rather than fairly presenting financial statements has continued in the Czech Republic [28, 29], and considerable differences between the Polish regulations and IFRS were identified given the legalistic and rule-based orientation of Polish rules [34]. Also, problems associated with lack of clarity in the fiscal law, a variable level of understanding of IFRSs by the regulators and preparers, the persistence of the communist mentality among accountants who gained their knowledge and skills prior the transition, the accountants' preference for more prescriptive regulation and less choice of accounting treatments, were also documented [34].

II. Differences from International Legislature

To summarize the current stage of accounting legislature, there shall be stated following "open chapters":

- absolute lack of definition of basic items of financial statements
- there does not exist any definition of assets, liabilities, equity, expenses or revenues
- application of "substance-over-form" rule when reporting the financial leases
- introduction of effective interest rate and amortized costs as a possible measurement base
- wider spread of fair value approach
- depends on the liquidity and transparency of markets

Within the following text we will discuss the major differences between Czech accounting practices and the IFRS for SMEs. In general there could be stated, that there is commonly used the historical costs approach rather than fair value accounting [26, 27].

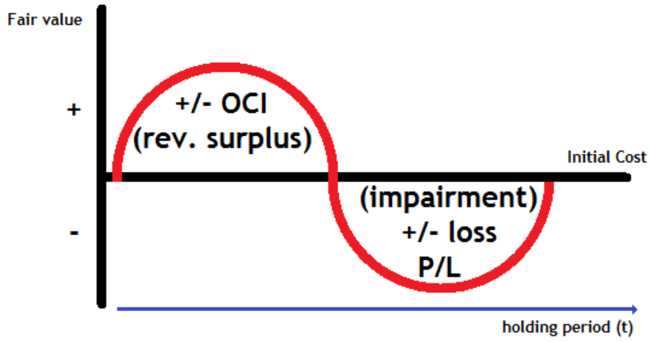
Intangibles

There could be stated that there are any significant differences from the measurement point of view. Like under IFRS for SMEs there are used costs upon initial recognition and costs less accumulated amortization and impairment losses upon balance sheet day. Useful life of intangibles in the Czech Republic is given by the Income Tax Act and there is expected that accounting unit will use the linear method of amortization. However under Czech legislation there are considered as intangibles incorporation expenses and research, which are not recognized as assets under international referential. The requirements on disclosed information are not specified in detail within Czech accounting legislature.

Tangible Assets

There could be stated that there are any significant differences from the measurement point of view for the category known under IFRS for SMEs as "Property, plant and equipment". Like under IFRS for SMEs there are used costs upon initial recognition and costs less accumulated depreciation and impairment losses upon balance sheet day. The requirements on disclosed information are not specified in detail within Czech accounting legislature.

When discussing the differences from "big-set" of IFRS there shall be also provided an alternative – revaluation model known under IAS 16 (respectively for intangibles under IAS 38) – see following figure [25]:

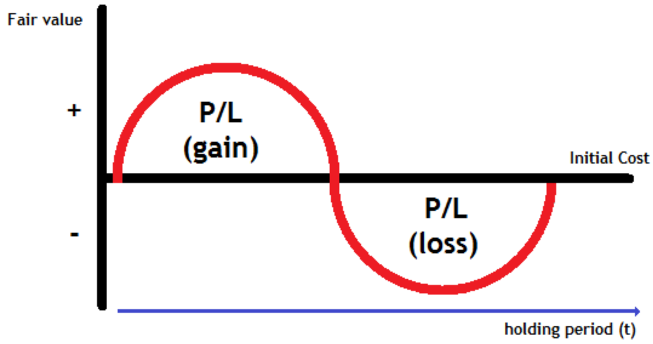


Based on the new measurement of fixed assets the depreciation is newly set which the entity will record for these assets. If there is an increase in the asset value, it consequently means an increase in depreciation in subsequent years. The profit is reduced through depreciation at a level which corresponds to the value that will be necessary to restore the asset at the end of its useful life. So the revaluation of fixed assets in this case does not allow the distribution of unrealized holding gains to the owners.

Investment Properties

Investment properties do not form a special category under Czech accounting regulation. Therefore there are used the very same rules like for any other tangible assets. This leads to the recognition of the difference from IFRS for SMEs, where is applied the fair value approach. The requirements on disclosed information are not specified in detail within Czech accounting legislature.

Treatment of investment properties could be clearly seen from the following figure [25]:



Leases

There are any significant differences for reporting of operational leases. The treatment of financial leases is totally different when applying Czech and international rules. Under Czech accounting regulation there is not applied "substance-over-form" rule and it is the lessor who recognizes the object of financial lease and depreciates it. Lessee is allowed just to post the rental payments as an expense of the period; however the rental payments have to be on straight-line basis due to the requirements of Income Tax Act. The requirements on disclosed information are not specified in detail within Czech accounting legislature.

Inventories

The treatment of inventories fully complies with IFRSs and there could not be seen any significant differences. However, the requirements on disclosed information are not specified in detail within Czech accounting legislature.

Financial Assets

Financial assets are measured upon initial recognition at cost. Upon balance sheet day there could be applied equity method or fair value approach for shares, and fair value approach for derivatives. Czech accounting however does not apply the amortized costs (or present values) as a measurement base. The division of bonds discounts or premiums shall be therefore straight-line based and the effective interest rate is not applied. The hedge accounting criteria are based on IAS 39 Financial instruments: recognition and measurement. The treatment of fair value hedge and cash flow hedge is very same like under "big set" of IFRS. The requirements on disclosed information are not specified in detail within Czech accounting legislature.

Receivables and Liabilities

Receivables and liabilities are measured at nominal values and it does not matter whether they are long- or short-term based. The amortized costs (or present values) as well as the effective interest rate are not applied. The deferred items are presented separately on balance sheet and not as a part of receivables or liabilities. Long-term receivables are reported as a part of current assets on balance sheet. The requirements on disclosed information are not specified in detail within Czech accounting legislature.

Provisions

Provisions are measured at nominal values. The time value of money is not applied upon Czech accounting legislature. The most popular provision in the Czech Republic, i.e. the provision on repair of tangible assets, is strictly prohibited under IFRS for SMEs. The requirements on disclosed information are not specified in detail within Czech accounting legislature.

III. Accounting Harmonization Measurement

Formal harmonization actually represents a first indispensable step in achieving material harmonization. Even though we accept the existence of alternative solutions and realities we believe that reaching the objective of financial reporting practices that are globally accepted requires an intermediate phase of harmonizing accounting regulations. Under these circumstances we consider that accounting harmonization represents a real process [30, 32] and seems to be essential in order to improve international comparability of financial statements, therefore increasing cash flows' mobility and reducing costs in terms of financial statements' preparation especially in the case of multinational companies [5, 7]. They consider that accounting harmonization assumes four essential aspects as follows: (1) the influences, (2) the process, (3) the result and (4) the consequences. The influences comprise those factors that have a certain impact on accounting practices' harmonization. The process assumes the assembly of steps or efforts that are developed by companies in order to reduce existent differences of accounting practices. The result refers to the level of harmony being reached at a certain moment in time. Consequences refer to subsequent effects of the harmonization process.

It is therefore necessary to make the distinction between the two main types of harmonization that are de facto or material harmonization and de jure or formal harmonization. References with regard to the increase of the comparability degree are based on a high degree of conformity of accounting practices and afterwards on harmonizing regulations [4]. They also consider that formal harmonization usually generates or favors material harmonization without this representing the only solution. More precisely, material harmonization can develop without being generated through formal harmonization as its predecessor, through the so-called spontaneous harmonization.

[30] also make a clear distinction between de jure harmonization and de facto harmonization. Through harmonization of accounting regulations (de jure harmonization) they analyze to what extent accounting standards and regulations are comparable. The latter concept (de facto harmonization) mostly analyzes to what extent accounting regulations are found within companies accounting practices [20]. [31, 32] also distinguish spontaneous harmonization besides formal harmonization and material harmonization. Furthermore, spontaneous harmonization represents a subcategory or a particular form of material harmonization [21]. The approach in accordance to which material harmonization can be reached without first going through formal harmonization is also argued by [32].

We can say that two main forces are involved within the international accounting harmonization process: (1) institutional efforts for international accounting harmonization through the development of common accounting rules and standards and (2) spontaneous efforts of global players in order to adopt accounting methods that should improve their communication with accounting information's users in other countries [4]. This two forces act simultaneously, consolidating each other, but in some cases acting independently under the umbrella of the globalization phenomenon.

Spontaneous accounting harmonization can be considered as a deviation from or alternative to the natural/classical evolution of the accounting harmonization process. Such a deviation incurs when some deficiencies characterize the process of harmonizing regulations or when the pace of this harmonization process does not correspond to financial reporting's need for comparability as expressed through accounting practices and realities. In other words we can consider that spontaneous harmonization is a reaction of response to the need for accounting harmonization coming from accounting practice. Spontaneous accounting harmonization therefore develops due to forces of the market and not to accounting regulations [21] and their harmonization.

We can observe that instruments measuring the compatibility degree of accounting practices and of different sets of accounting regulation actually record a convergent time evolution towards the common point given through measurement instruments based on similarity. Moreover, a clearer dimensioning of the accounting harmonization degree is obtained when using either association coefficients (Jaccard's Coefficients, Roger-Tanimoto Coefficient, Lance-Williams Coefficient), either correlation coefficients (Pearson Coefficient, Spearman Coefficient).

We will discuss now the compatibility levels between all sets of national harmonization with international referential. For the compatibility calculation were used Jaccard's coefficients (for measurement of similarities and dissimilarities), Roger-Tanimoto coefficient (for measurement of similarities) and Lance-Williams coefficient (for measurement of dissimilarities).

Jaccard's Coefficients are calculated as follows:

$$S_{ij} = \frac{a}{a+b+c} \qquad (1)$$

and

$$D_{ij} = \frac{b+c}{a+b+c} \qquad (2)$$

where:

S_{ij} represents the similarity degree between the two sets of analyzed accounting regulations or practices; D_{ij} represents the degree of dissimilitude or diversity between the two sets of analyzed accounting regulations or practices; a – the number of elements which take the 1 value for both sets of regulations or practices; b – the number of elements which take the 1 value within the j set of regulations or practices and the 0 value for the i set of regulations or practices; c – the number of elements which take the 1 value within the i set of regulations or practices and the 0 value for the j set of regulations or practices.

The values that can be recorded by these coefficients go from 0 to 1, where 1 represents a maximum level of harmonization when considering the similarity coefficient. Also, the sum of the two Jaccard's Coefficients, Jaccard S_{ij} and D_{ij}, is obviously always equal to 1.

As another model for measuring the consistencies between accounting systems could be considered Roger-Tanimoto coefficient. The computation formula is following:

$$R\&T = \frac{d+a}{d+a+2(b+c)} \qquad (3)$$

where:

d – the number of elements which take the 0 value for both sets of regulations or practices.

Alternatively for measuring of dissimilarities could be used Lance-Williams coefficient. The computation formula is following:

$$L\&W = \frac{b+c}{2a+b+c} \qquad (4)$$

All sets of accounting regulations were tested within 8 particular areas: (i) intangible assets, (ii) PPE, (iii) investment properties, (iv) financial leases, (v) inventories, (vi) financial assets and liabilities, (vii) financial derivatives, and (viii) financial statements. Discussed issues are part of Appendix. Tables 1 and 2 provides evidence about measurement of similarity and dissimilarity level between all accounting regulations (Czech, IFRS, IFRS for SMEs).

Table 1. Similarity Analysis between Czech System and IFRSs

System		CZE	IFRS	SME
CZE	JC	1.0000	0.5455	0.5667
	RT	1.0000	0.3750	0.4348
IFRS	JC	0.5455	1.0000	0.8621
	RT	0.3750	1.0000	0.7838
IFRS/SME	JC	0.5667	0.8621	1.0000
	RT	0.4348	0.7838	1.0000

Source: own analysis

Table 2. Dissimilarity Analysis between Czech System and IFRSs

System		CZE	IFRS	SME
CZE	JC	0.0000	0.4545	0.4333
	LW	0.0000	0.2941	0.2766
IFRS	JC	0.4545	0.0000	0.1379
	LW	0.2941	0.0000	0.0741
IFRS/SME	JC	0.4333	0.1379	0.0000
	LW	0.2766	0.0741	0.0000

Source: own analysis

Results proof the close linkage between big set of IFRS with separate standard IFRS for SMEs. Czech accounting system is slightly closer to IFRS for SMEs, however there shall be pointed out the major differences as follows:

- facultative preparation of Cash Flow Statement and Statement of Changes in Equity under Czech accounting system,
- application of "form-over-substance" for financial leases treatment in Czech
- much lower level of disclosure.

IV. Accounting Treatment of Mergers

Authors usually describe merger as a process of joining two or more companies. Merger could be friendly or hostile. Merger is a process which usually takes more than 6 months and after the successful finish at least one company must dissolve. Only one successor company continue with its activities.

The merger is concerned as a cross-border if there is satisfy that at least two of the involved companies have its seats in two different countries. In the recent years (2008-2011) there was an increase of cross-border mergers provided. This type of acquisition is more and more popular in the Europe. Due to growing number of cross-border mergers it is necessary to describe regulation process in the Europe and in the Czech Republic and also point out some obstructions occurred from regulation.

The important part of the cross-border merger is preparation of the Common Draft Term of cross-border merger. This name replaced the original Merger agreement. Due to the harmonization of the cross-border merger Common Draft Term the Directive specifies the minimum content of this document:

- legal form, name and address of the merging companies and successor company,
- exchange ratio of new issued securities on Stakes by successor company for dissolving companies and if necessary the amount of any cash surcharge,
- conditions for allotment securities which represent the proportion of registered capital of successor company created by cross-border merger,
- presumable impact of cross-border merger on employment,
- date from which the holding of securities, which represent the proportion of registered capital of successor company created by cross-border merger, entitle the holder to share in the profit and other special conditions associated with the holding,
- date from which the transactions in the accounting are considered to be the transactions of successor company created by cross-border merger,
- other rights which successor company provides to the securities holders or shareholders, except of payment of profit,
- special benefits granted to the experts who study the Common Draft Term of merger, then to shareholders, members of management, control and administrative authorities,
- statutes of successor company created by cross-border merger,
- potential procedures of employee involvement in determining their rights,
- information about the valuation of assets and liabilities transferred to successor company created by cross-border merger,
- date of financial statement of merging companies used to established the conditions of cross-border merger.

The goal of this research is to analyze available Common Draft Terms in the Czech Republic and provide important information and short database to the reader. During this research, there will be dealt with following hypotheses:

[1] *The implementation of 10th European Directive no. 56/2005/EC on Cross-border mergers destroyed barriers of executing of cross-border mergers.*

[2] *After an implementation of 10th EU Directive into Czech national law the number of cross-border mergers rapidly increased.*

[3] *Regulation of cross-border mergers after an implementation of 10th Directive is unique in the Member States*

[4] *Common Draft Terms of merging companies from Czech Republic are similar and contains all law requirements*

The mentioned hypotheses were researched by studying legislatives in the EU, especially in the Czech Republic. Afterwards our research emanates from available Common Draft Terms agreed in the Czech Republic.

Research is focused on analyses of all available Common Draft Term with involved Czech companies from 2008 to end of August 2011. Analysis of 44 Common Draft Terms search for mentioned differences and availability of types of cross-border Mergers among EU. The main difference and reason for disability of performing mergers we expected different description of Decisive day.

The Common Draft Terms prepared after an obligatory implementation of 10th EU Directive was the subject of our research. Despite the last term of implementation 10th Directive was the end of Dec 2007, in Czech Republic this Directive effective date was 1st July 2008. After this date, the new law was issued and effective – Act no. 125/2008 about Companies Transformation.

Except of worrying of new legislative, the late implementation was the main reason that in 2008 only four Common Draft Terms was published.

From this sampled data in 2008, only one successor company took place in the Czech Republic. Other two successor companies took seat in Cyprus and one in the United Kingdom. All of mentioned cross-border mergers had been validate by Czech Commercial Register, usually by a letter from abroad similar Register (i.e. English Companies House). The Decisive day was set in the year 2008 and the validity of these mergers was set retroactively by the law of successor companies.

Only one of named Common Draft Terms was prepared according Czech law. It was the one when the Successor Company had it seat in the Czech Republic. In this case the accounting aspects really occur from the Decisive Day and the legal acceptance of this contract was by Czech law on 9th December 2008.

In the other cases, the Czech Commercial Register just erased the dissolving company from Register according to the letter from foreign similar institute. Legal aspects of this merger validate the Register abroad.

In 2009 there has been ten Common Draft Terms published in the Commercial Bulletin. The low number of provided cross-border mergers during the year 2009 says, that the change in Czech law doesn't increase number of mergers dramatically. Ten mergers cross-border is not so much. The problem should be also in the Financial crisis which culminated in 2009. Ernst & Young, one of the world's leading professional services firms, unveiled a report titled "Mergers and Acquisitions 2009". According to the report 171 deals were recorded in 2008, while this figure fell to 116 in

2009. Of these deals the value of 51 has been disclosed, accounting for 44 percent of the total. The total volume of deals conducted in the last quarter of 2009 fell to $3.9 billion, while this figure was $16.3 billion in the same period of 2008, despite the fact that the crisis started to take its toll on the economy as of this period.

Because of persisting financial crisis in 2010, we can register only 15 Common Draft Terms with Czech Company involved. All of mentioned mergers was accepted by law and took legal effect. The most common mergers were between Czech and Slovak companies. The legislation of these two countries is very similar and because of this the cross-border mergers should be provided without problems.

Following the research outputs, first hypothesis should be neither accepted nor rejected. The implementation of 10th Directive EC was the step forward and destroy some barriers. On the other side, the various implementation of European Directive no. 2005/56/EC into legislative of Member States caused even greater complications. In our opinion, nineteen realized cross-border mergers in Czech Republic is not so much. The most common reason is different implementation of the date when the accounting aspects of mergers occurs – decisive day.

The second hypothesis should be rejected. The number of realized mergers after an implementation didn't increased rapidly. We believe after pointing out on some differences in Member States legislations which hinder providing cross-border mergers, governments of Member States should novelize law and go near to other legislations. This should increase the number of cross-border mergers. Czech Republic has a novelization draft prepared, but it is a long process to accept it by a government.

Third hypothesis should be rejected too. Legislation about cross-border mergers is not unique in the EU and it causes complication of merging. This paper was focused on the main difference – decisive day. There is ineluctability to unique cross-border merger legislative as soon as possible to allow free movement of capital among Member States.

Last hypothesis shall be accepted. Although there are huge differences of size of common draft terms in Czech Republic, the legal requirements are fulfilled.

V. CONCLUSION

IFRS information can help companies involved in buying or selling goods or services across national borders to initiate new relationships with customers and suppliers. As the spread and acceptance of IFRS grows internationally, so does the importance of IFRS financial statements as a tool to cultivate a positive image.

Having financial information that is universally understood and comparable to other companies' information can improve relationships with customers, suppliers, investors and bankers. If these business partners have more confidence in the financial information being provided using IFRS, this can be a crucial factor in securing a new supplier, obtaining finance, reducing the cost of borrowing, and arriving at an acquisition or cooperation agreement.

Adoption of IFRS could be vital for true-and-fair view and for the higher comparability of accounting information in globalized world. The crucial necessity will be the wider spread of IFRS knowledge. Generally, IFRS is based on different concept than continental accounting regulation, so it'll be not only about the training of new accounting regulation, but about the training of the different accounting thinking and different approach for posting of accounting transaction. There will be also necessary to provide regular information for professional accountants about the evolution and changes in IFRS and the long-life training.

As a possible limit for the current adoption of IFRS could be considered the lack of motivation as the clients of professional accountants prefer rather than true-and-fair view the best solution of accounting operation from the tax point of view, due to the close connection of national accounting systems to tax regulation.

APPENDIX

	CZE	IFRS	SME
1 Intangibles			
Initial Recognition			
• historical costs	x	x	x
Revaluation			
• historical costs	x	x	x
• fair value (up-equity, down-P/L)		x	
2 PPE			
Initial Recognition			
• historical costs	x	x	x
Revaluation			
• historical costs	x	x	x
• fair value (up-equity, down-P/L)		x	
3 Investment Properties			
Initial Recognition			
• historical costs	x	x	x
Revaluation			
• historical costs	x	x	
• fair value (P/L)		x	x
4 Financial Leases			
Lessor			
• recognition of fixed asset at historical costs	x		
• depreciation of fixed asset	x		
Lessee			
• depreciation of fixed asset		x	x
• recognition of fixed asset at present value		x	x
• off balance sheet evidence of fixed asset	x		
5 Inventories			
Initial Recognition			
• historical costs	x	x	x

Derecognition			
• FIFO	x	x	x
• weighted average	x	x	x
6 Financial assets and liabilities			
Initial Recognition			
• historical costs	x	x	x
• fair value		x	x
Derecognition			
• historical costs	x	x	x
• present value		x	
• amortized costs	x	x	x
• fair value (P/L)	x	x	x
7 Derivatives			
Initial Recognition			
• historical costs	x		
• fair value		x	x
Derecognition			
• fair value (P/L)	x	x	x
• fair value (equity)	x	x	x
8 Obligatory Financial Statements			
• Balance Sheet (Statement of Financial Position)	x	x	x
• P/L Statement (Statement of Financial Performance)	x	x	x
• Statement of Comprehensive Income		x	x
• Statement of Changes in Equity		x	x
• Cash-flow Statement		x	x
• Notes	x	x	x

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J. Strouhal is Senior Lecturer at the University of Economics Prague, Czech Republic. He published more than 400 research outputs (among them 20 books, 9 ISI papers and around 30 SCOPUS papers). He is a reputed practitioner currently also being President of Chamber of Certified Accountants Czech Republic. His major is international accounting harmonization and its impact on financial decisions.
C. Bonaci is Lecturer at Babes-Bolyai University Cluj Napoca, Romania. She is a certified accountant. Her major is financial instruments reporting and international harmonization.
R. Sklenár is Ph.D. student at the University of Economics Prague, Czech Republic. His major is reporting and measurement of mergers and acquisitions.