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Contact to corresponding author: homola@utb.cz; Tomas Bata University in Zlín, Faculty of Management and Economics, Mostní 5139, 760 01 Zlín, the Czech Republic

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David Homola
Tomas Bata University in Zlín, Czech Republic
orcid.org/0000-0001-6791-5094

Marie Paseková
Tomas Bata University in Zlín, Czech Republic
orcid.org/0000-0001-5400-4099

Factors influencing true and fair view when preparing financial statements under IFRS: evidence from the Czech Republic

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Keywords: *accounting; true and fair view; misstatement; IFRS; financial statements*

Abstract

Research background: Accounting records provide a wide range of data necessary for decisions of the management as well as for users of a company's financial statements. IFRS represents one of the widely accepted accounting principles, often mentioned in relation to the preparation of high-quality financial statements.
Purpose of the article: The aim of this paper is to identify the factors contributing to the occurrence of misstatements when preparing financial statements under IFRS. The subsequent goal is to identify the possible influences of such misstatements on the users of the financial statements.
Methods: The research itself focuses on perceived problems in IFRS application in the Czech Republic. The total tested population is 193 Czech companies preparing their financial statements under IFRS. Descriptive statistics, the chi-square test of independence along with proportional tests, are used for the statistical data analysis.
Findings & Value added: The results indicate that, while misstatements in accounting do not occur regularly, a statistical dependence can be shown be-tween the frequency of misstatements occurrence and the average size of mis-statements. The frequency of the subsequently identified misstatements is also proven to be statistically dependent on the average size of misstatements. The IFRS themselves are not proven to influence misstatement occurrences in financial state-ments, which is in contrast with previous studies. Managerial pressures, similarly to other studies, are proven by the research to be affecting the quality of accounting information. This paper

broadens the literature on the factors influencing the quality of financial statements prepared under IFRS and simultaneously reaches conclusions disproving the frequently noted bene-fits of IFRS implementation.

Introduction

Accounting data serves as the primary source of information for managers, and based on this information, managers decide about the future development of their companies. The data within the financial statements can also be widely used. Thus, it should be without errors, mistakes or intentional manipulations, so that decisions based on them are correct. A true and fair view of accounting information is therefore essential to all types of users, be they internal employees or external entities. However, providing high quality accounting data is an increasingly daunting task incorporating several elements. Without understanding the basic principles of accounting and truly enforcing them, the probability of creating high quality financial statements is low.

Within individual countries, the laws are continuously evolving and changing, new rules are being applied and, finally, globalization affects accounting. The International Financial Reporting Standards (IFRS), the primary universal accounting guidelines, are currently applied in most countries, including the Czech Republic. IFRS are typically used as mandatory accounting principles for publicly traded companies. For Czech accountants, it is necessary to be familiar with IFRS, which differ significantly from CZ GAAP. Of course, the application of IFRS may still lead to errors, which may significantly affect company financial statements and the subsequent decisions of their users. Not only are IFRS difficult for accountants to implement, but they may result in pressures from managers, who want company financial results presented in a more favorable way. Such pressures on accountants may significantly impact the quality of the financial statements they prepare.

This article focuses on accounting errors and intentional manipulations, and whether such failures may have significantly negatively altered the financial statements of companies. We first concentrated on misstatements in general. Then, our research targeted misstatements stemming either from the application of IFRS (a tool with which Czech accountants are still coming to terms) or from pressures from management to alter financial results.

The research itself is performed on a sample of Czech enterprises that prepare their financial statements under IFRS, in the form of a questionnaire survey, focusing on perceived problems in IFRS applications in the Czech Republic. The data was collected in 2018 and 2019. The total population of respondents is 193. The data is examined by means of descriptive and mathematical statistics, especially using the chi-square dependency tests using contingency tables and proportional tests. The strength of the dependence was assessed using Cramer's V coefficient.

The remainder of this paper is as follows. In the first section, a detailed literature review provides a summary of the necessary background as well as information about existing papers on the topic. The research methodology section contains descriptions of the quantitative research performed and the statistical methods used to analyze the obtained data. The results section includes detailed information about the findings of our research, that are subsequently compared with existing research and commented on in detail in the discussion section. The last section concludes the study.

Literature review

The primary purpose of accounting and financial statements is to provide information, mainly in the form of quantitative data which is subsequently used by respective users for their specific needs. Accounting information is an essential source of data about a particular company (Otrusinová & Šteker, 2013, pp. 436–443). Accounting principles and guidelines must be followed in order to create information that truly and faithfully represents the situation of a given company (see, e.g., Romolini *et al.,* 2015, pp. 55–77).

Users of accounting information can be external or internal, with internal users generally having greater access, while external users have to rely only on financial statements (Porter & Norton, 2018, pp. 83). Internal users usually consist of managers, accountants, employees of controlling and internal audit departments and shareholders. Creditors, state authorities, banks and other possible investors are usually referenced as examples of external users of accounting information (Porter & Norton, 2018, pp. 95). Another way to categorize users is as follows: suppliers of capital (shareholders, investors, and banks), business and social partners (providers, customers, and employees), state (government, local authorities, and tax authorities) and other users (management, analysts, consultants, auditors, and the public) (Sîrbulescu & Tonea, 2015, pp. 343-–348).

Quality accounting information presented in the form of financial statements has been a point of interest of researchers worldwide due to the fact that it is an essential source of data for decisions of any user, be they internal or external. Those focusing on the quality of accounting information include, e.g., Cernusca *et al.* (2016, pp. 63–87), who focused on negative impacts of creative accounting on the quality of financial statements. Another summary of the impacts of accounting errors can be referenced in the work of Jones (2011, pp. 236–267), who details possible negative impacts of misstatements on users and describes potential factors influencing their occurrence. Türkmen (2016, pp. 77–83) focuses on the effects of frequent errors and acts of fraud in SME financial statements, concluding that companies tend to manipulate their financial statements, most commonly to obtain bank credit. Deaconu *et al.* (2016, pp. 105–119) argue in favor of reliable, fair value estimates that enable accurate decision making for stakeholders of the financial reporting market. Krištofik *et al.* (2016, pp. 157–175) contend that providing non-financial information in financial statements enhances their quality and decreases the risk of misstatements in them.

Fulfilling the requirements of internal or external users is conditioned by the fact that the provided data is of sufficient quality, which is confirmed in research by Bai *et al.* (2012, pp. 453–473). Chaudhry (2016, pp. 123–159) suggests that users can achieve a better picture of a company's situation if they objectively analyze the data included inside financial statements rather than blindly trusting information presented in them. Fundamental qualitative characteristics of accounting information require the information to be provided error-free when users need it, and the information should be of importance to the user.

If information is not presented to users in a timely fashion, it loses value (Pucian *et al.*, 2011, pp. 50–55). Baba (2009, pp. 59–66) agrees that to be able to quickly meet the accounting information requirements of users, it is necessary to incorporate sufficient methods.

Accounting is such a vast and complicated area that it is hardly possible to mitigate all risks of potential mistakes or errors. Yu and Lu (2009, pp. 194–197) focus on the quality of accounting information since 2008, concluding that insufficient independence in corporate decision making bodies as well as in other entities, such as auditors, is the leading cause of unreliable information being presented to the public. Other causes were also identified, such as an underdeveloped macroeconomic environment or faulty mechanisms for incentive distribution.

The idea of a true and fair view of accounting information is incorporated into most accounting standards. This requirement is also clearly stated in the document "True and Fair" (FRC, 2014) presented by the International Accounting Standards Board, in which it clearly states that the application of legal and accounting requirements is fundamental to ensure a true and fair view. Yang *et al.* (2005, pp. 194–228) confirm that stricter standards provide more reliable accounting information. Chen *et al.* (2007, pp.

541–565) and Petroni *et al.* (2000, pp. 95–125) disagree with Yang *et al.*, while Chaney *et al.* (2011, pp. 58–76), and Ramesh and Revsine (2000, pp. 159–186) conclude that too much accounting freedom leads to a higher number of misstatements, supporting the findings of Yang and his team. If financial statements include something that does not adhere to the true and fair view, this is usually referred to as misstated financial statements or financial statements with misstatements.

Misstatements are a reoccurring problem in the world of accounting and finance. Auditors explicitly target misstatements. The international standards of auditing (ISA) provides the following definition: *"a misstatement is a difference between the required amount, classification, presentation, or disclosure of a financial statement line item and what is reported to achieve a fair presentation, as per the applicable accounting framework."* (ISA, 2010). Accounting misstatements, intentional or otherwise, significantly decrease the quality of financial statements if they are not identified promptly. Chaney *et al.* (2011, pp. 58–76) conclude that the main reason for misstatements is that some accountants or managers do not think when recording transactions and only automatically record transactions based on set rules, and the company management blindly trust their work. This blind trust usually results in errors, which remain undetected and are transferred into company financial statements.

Misstatements can generally be divided into errors and frauds. An error is defined as a specific deviation from the standards or a situation that may result in breaking the rules. The human element and the information technology element comprise two main reasons for error occurrence (Dušek, 2011, pp. 133–145). The magnitude of an error creates another distinction; there can be insignificant errors, which should not be material to users of accounting information, and significant errors which may affect user decisions (Mamo, 2014, pp. 464–499). Another type of misstatement is a fraud, which is significantly different than an error. Adali and Kizil (2017, pp. 171–187) state that the main difference is that fraud is intentional as opposed to an error. Financial fraud is a broad term with many potential variations. Zhou *et al.* (2011, 570–575) define it as the usage of illegal methods or practices to obtain benefits. Vlčková and Friebel (2015, pp. 58–69) focus on factors affecting the true and fair view of accounting information and identify creative accounting and other illegal practices as one of the key factors influencing the quality of accounting information. Management can pressure accountants to modify, adjust or outright manipulate financial statements. Such pressures significantly affect the true and fair view of accounting information, which was noted by many previous studies (see

Vladu & Cuzdriorean, 2014, pp. 695–703; Dechow *et al*., 2012, pp. 275–334; Gerakos, 2012, pp. 335–347; Badertscher *et al*., 2009, pp. 63–97).

For many years, Czech companies had been preparing their financial statements in accordance with standards commonly used in their country, popularly known as generally accepted accounting principles (GAAP). Paseková e*t al.* (2019) concluded that the Czech GAAP is a sophisticated accounting system, which is effective in preventing financial misstatements. However, the Czech Republic is also subjected to EU Regulation 1606/2002 on the application of international accounting standards. This regulation stated that for accounting periods after 2005 companies which are publicly listed have to prepare their financial statements in line with International Financial Reporting Standards. The implementation of IFRS proved daunting to many older accountants. Even now, Czech companies have problems with their smooth implementation. Kubickova and Jindrichovska (2016, pp. 64–77) note that the adoption of IFRS improves the quality of accounting information and creates transparency for investors. Tassadaq and Malik (2015, pp. 544–551) investigate the probability of financial misstatements when applying IFRS. Their research targets the relationship between creative accounting and international accounting standards. They conclude that IFRS application improves the quality of financial statements. Remenarić *et al.* (2018, pp. 193–199) also present the adoption of IFRS as an effective method of preventing misstatements.

Research methodology

The survey to obtain quantitative data was conducted in 2018 and 2019 in the form of a questionnaire. The questionnaire content included a total of 26 questions about accounting misstatements in the questioned companies, their elimination, as well as about IFRS and possible impacts of using IFRS on the occurrence of corporate financial statement misstatements. The questions were prepared in line with previous studies and pretested on a sample of 20 respondents. The questionnaires were addressed primarily to accountants, managers and other individuals included in the creation of financial statements. We received 193 completed questionnaires from companies that report under IFRS. The companies were selected by random sampling from the Czech database Albertina. A total of 287 companies were contacted by email and asked to complete an online questionnaire. The response rate was 67.25 %. The survey was completed by companies online.

In order to analyze the obtained responses, the chi-square test of independence and proportional tests are used. Cramer's V coefficient is utilized to comment on the strength of individually identified dependencies. In addition to statistical tests, the data is analyzed using descriptive statistics tools, and all testing is performed at a 5% significance level. The data was analyzed using both the SPSS statistical program and the JASP statistical application.

The statistical analysis aims to determine how accounting errors and other misstatements occurred in tested companies, and how such misstatements may influence the explanatory power of financial statements prepared under IFRS, as well as whether IFRS may be the cause of problems. The first part of the study analyses accounting misstatements, the frequency of their occurrence, their relative size, and whether the misstatements were found or if they even remained in the final version of financial statements presented to users. The latter part of the research focuses on the use of IFRS in companies and the existence of managerial pressures to manipulate financial statements, and their possible impacts on the occurrence of misstatements.

In this paper, an accounting misstatement is any mistake in the financial statements. The relative size of accounting misstatements is categorized in line with International Standards of Auditing (ISA 30) for calculating the materiality levels. The categories were created with the advice of Czech auditors. The threshold for significant misstatements was established as 1 percent of the total assets of the company. The following hypotheses were set for data testing:

H1: "*The frequency of misstatement occurrence is not dependent on the relative size of the misstatements.*"

H2: "*The frequency of the subsequently identified misstatement occurrence is not dependent on the relative size of the misstatements*."

H3: "*The frequency of misstatement occurrence decreases as accountants´ trust in the IFRS effectivity increases."*

H4: "*The complexity of IFRS implementation negatively influences the frequency of misstatement occurrence.*"

H5: "*The willingness of accountants to adjust financial statements is not positively correlated with the strength of managerial pressures on accountants."*

H6: "*The frequency of misstatement occurrence is not dependent on the managerial pressures to alter financial information.*"

Results

The initial focus of the data analysis was misstatement occurrence. Most of the respondents stated that they seldom made accounting misstatements (66.3%), but only just over 27% of the companies were confident that normal accounting misstatements do not occur in their reports. When focusing on the average misstatement size, we determined that the occurring misstatements were mostly insignificant (65.8%) or minor (31.6%); significant misstatements were encountered by only 2.6% of respondents. Then, we tested the hypothesis of independence between the frequency of misstatement occurrence and the relative size of the misstatement using the chi-square test of independence. Cramer's V coefficient of 0.3920 indicates a medium-strong dependency between the frequency of misstatement occurrence and the relative size of the misstatement (p-value<0.0001, criterion=29.654). These findings indicate that the number of insignificant misstatements decreases with the frequency of occurrence of the misstatements. This finding can be understood as follows: companies with more misstatements also have a higher probability of making significant misstatements than the companies that do not misstate. Detailed answers to the related questions are summarized in Figure 1. This is why hypothesis H1, "*the frequency of misstatement occurrence is not dependent on the relative size of the misstatements*," is denied.

Next, we focused on misstatements in financial statements, which were not identified and were presented to the public, but were identified (by auditors or other entities) in subsequent periods. 15.02% of accountants confessed to having misstatements in their financial statements that are identified only subsequently, while 84.98% of respondents claim to have never or seldom experienced such a misstatement. We tested the dependency of the occurrence of these misstatements on their respective size. A summary of findings can be referenced in Figure 2. The analysis of the data indicated that the frequency of misstatements, which are subsequently identified, is higher for relatively more significant misstatements. From this, it can be concluded that subsequent controls (of tax offices, banks or auditors) focus primarily on significant misstatements and generally skip over insignificant misstatements. The existence of dependency between the occurrence of subsequently identified misstatements and their relative size was also performed using Cramer's V. The calculated coefficient 0.5418 (p-value<0.0001, criterion=56.663) indicates a fairly strong dependency between the two variables. That is why hypothesis H2, "*The frequency of the subsequently identified misstatement occurrence is not dependent on the relative size of the misstatements*," is also denied.

In the next part of the study, we focused on the approaches of accountants, managers and companies in relation to the financial statements prepared according to IFRS. Our questions targeted the experience of accountants with IFRS, the complexities of their application, and possible impacts of IFRS on misstatement occurrence. We also focused on managerial pressures on accountants to manipulate financial results, how accountants feel about these pressures, and the usual results of such pressures in companies preparing their financial statements in accordance with IFRS. Over 56% of the respondents answered probably yes, and over 11% definitely yes, when asked if IFRS effectively prevent misstatement occurrence, leaving only 32.3% of the responses at probably or definitely no. These results indicate the relative albeit not dominant faith of accountants in IFRS. Answers concerning the complexity of IFRS application were not as decisive. 52% of respondents think that problems with IFRS application may lead to misstatements. Answers to these questions can be referenced in Figures 3 and 4, respectively. Statistical dependency between the ability of IFRS to prevent misstatement occurrence in financial statements and the frequency of misstatements was tested. The results indicated no relation.

Similarly, the dependency of the misstatement occurrence rate and the complexity of IFRS implementation was tested. No significant relation was identified. In conclusion, accountants did not reach statistically significant agreement on whether or not IFRS can influence misstatements. Thus, hypothesis H3, "*The frequency of misstatement occurrence decreases as accountants´ trust in the IFRS effectivity increases*," and hypothesis H4, "*The complexity of IFRS implementation negatively influences the frequency of misstatement occurrence*," are denied.

Afterwards, we focused on managerial pressures on accountants in companies applying IFRS. From 193 study respondents, 34 reported pressure from management to manipulate accounting information. This represents a 17.6% of all accountants, which is an unexpectedly high amount. We also asked the respondents for their personal opinions on intentional manipulation of financial statements. 62.2% responded that sometimes it is acceptable to use accounting standards (namely IFRS) to present the financial information in a way that companies prefer, even though it means slightly bending the rules. 8.3% of respondents even admitted to doing it frequently. We have statistically tested whether there is a relation between managerial pressures to manipulate financial information and opinions of accountants on the acceptability of intentional manipulation. We calculated a Cramer's V coefficient of 0.3017 (p-value=0.0002, criterion=17.565) for this relation, which confirmed the existence of statistical dependency, although weak. Thus, hypothesis H5, "*The willingness of accountants to adjust financial statements is not positively correlated with the strength of managerial pressures on accountants*," is denied. This finding indicates that the acceptance of financial manipulation by accountants increases in proportion to the willingness of the management to manipulate the financial statements. These findings may be possibly explained by managers hiring employees who are more likely to share their values and accept their approaches. This finding was also supplemented by a relatively strong dependency (Cramer's V=0.5516, p-value<0.0001) between management's willingness to manipulate the financial statements prepared according to IFRS and the accountant´s acceptance of financial information manipulation. The frequency of acceptance, by accountants and managers in the same company, seems to follow the same trend, which can be referenced in Figure 5.

The final part of our study examines the influence of managerial pressures on misstatement occurrence in financial statements prepared under IFRS. We tested a hypothesis of independence between the frequency of misstatement occurrence and the managerial pressures to alter corporate financial data using the chi-square test of independence. A Cramer's V coefficient of 0.1626 indicates a weak dependency between these variables (p-value=0.024, criterion=5.105). In conclusion, hypothesis H6, "*The frequency of misstatement occurrence is not dependent on the managerial pressures to alter financial information,*" is denied. These findings indicate that misstatements occur more frequently in proportion to the strength of managerial pressures to modify the financial statements. A possible explanation is that, with increasing pressure from management, the accountants eventually give in and adjust the financial statements as requested. The existence of dependency was also proven between managerial pressures and the relative size of accounting misstatements (Cramer's V=0.2114, p-value=0.0033). The existence of such a dependency can be explained by the fact that management is usually focusing on significant adjustments to reach their goals and thus, in companies where there is more pressure to adjust, the actual misstatements are also larger.

Discussion

The results of our study show that accounting misstatements were not regularly occurring in the tested companies, i.e., misstatements occurred rarely. 15.02% of accountants admitted to having misstatements in their financial statements, which were identified only subsequently. Still, the findings are surprisingly high when compared to the results of other authors, such as Srinivasan *et al*. (2014, pp. 1201–1240), who stated in their research that 7.3% of companies have misstatements occurring in their financial statements. Our results indicate a more significant proportion of misstating companies, which may be caused by the fact that our research directly confronts corporate accountants, rather than focusing on the management's opinions or assessing only publicly presented cases. From this information, it can be concluded that the actual number of misstating companies may be higher than previously believed, with a significant proportion of misstatements remaining hidden.

The fact that the frequency of misstatement occurrence is correlated with the relative size of an error is also in line with previous studies such as Eilifsen (2000, pp. 1–43) or Yu and Lu (2009, pp. 194–197), confirming the assumption that relatively small misstatements tend to be overlooked by auditors, tax offices or anyone checking the financial statements for validity. However, our results were not able to prove the positive impacts of IFRS implementation on the quality of financial statements. Quality improvements are used to promote IFRS implementation, and several scholars also confirmed these improvements (see Kubickova & Jindrichovska, 2016, pp. 64–77; Tassadaq & Malik, 2015, pp. 544–551; Remenarić *et al.*, 2018, pp. 193–199). One of the possible explanations might be country specifics. Confirming the benefits of IFRS implementation among individual countries could prove to be an area of interesting future research.

Our other results indicate that 17.6% of accountants who prepare financial statements under IFRS have experienced managerial pressures to manipulate accounting information. This finding was unexpectedly high but is not entirely outside of the norm, as similar (albeit lower) conclusions on managerial pressures to manipulate financial statements have been drawn in other studies (see Healy & Wahlen, 1999, pp. 365–383, for a summary of these papers). The significantly higher percentage of managerial pressures on accountants may stem from Czech history or personal specifics of Czech managers. This difference could also represent interesting future research, which would compare the experiences with managerial pressures between accountants in different countries. The existence of a relationship between managerial pressures and the frequency of misstatement occurrences is in line with previous studies noted in the literature review section of this paper and further adds to the existing literature on this topic.

Conclusions

Financial statements that adhere to the true and fair view requirement are necessary for a wide range of decision-making processes. This issue will remain important as long as accounting scandals keep appearing.

The aim of this paper was to analyze factors that contribute to the occurrence of misstatements in financial statements and to evaluate their possible impact on the users of these financial statements. In this study, we focused on companies operating in the Czech Republic, which prepare their financial statements under IFRS.

Using statistical methods on a data sample of 193 companies, we concluded that the rate of misstatement occurrence in our sample is more substantial than in previous studies. While subsequently identified misstatements occurred rarely, they did occur and remained in the financial statements, which were presented to their potential users. These misstatements may impact the decisions of any user of the financial statements, although the tested companies claimed that misstatements usually are insignificant. The data also confirmed the relationship between the frequency and the relative size of misstatements. The impact of managerial pressures on misstatement occurrences was also confirmed. Our findings differed from previous findings on the importance of IFRS and its effects on the quality of accounting information, as the data did not confirm these assumptions.

We confirmed most of the findings of previous authors, but in general, the occurrence of misstatements was more frequent in our results than in other results. This difference may indicate possible future research, which could focus on the benefits of IFRS implementation between individual countries, as the results for the Czech Republic seem to differ from other countries, or could focus on misstatement occurrences from the point of view of accountants in different countries as opposed to most of the studies, which focus mainly on audit results or management representations. Also, for practical implications, these results could represent a warning sign when comparing the financial statements of companies operating in developed markets with financial statements of Czech companies. A higher level of skepticism should be used when comparing such data sets.

Obviously, this study has its limitations, one of which is the sample size, which could have been larger to provide more representative results. This research was also conducted in the Czech environment, which constitutes a limitation in its own right, but also presents an opportunity to conduct similar research in different countries and to compare the collected data internationally.

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Annex

Figure 1. Frequency of the misstatement's occurrence in relation to the average misstatement size

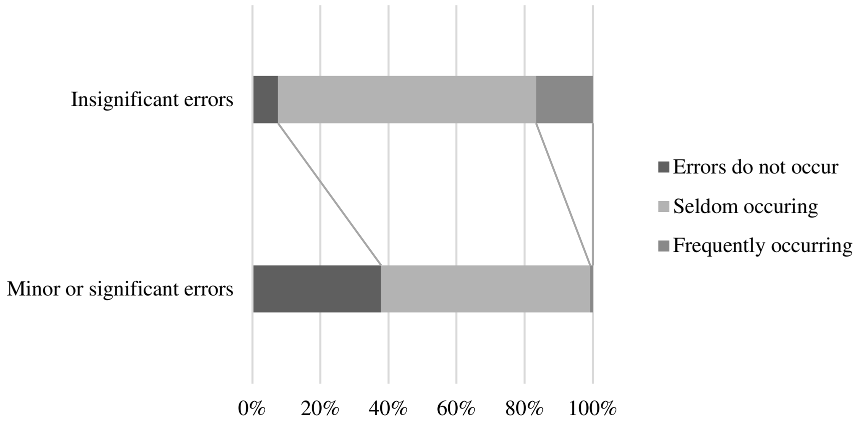

Figure 2. Frequency of the subsequently identified misstatement's occurrence in relation to the average misstatement size

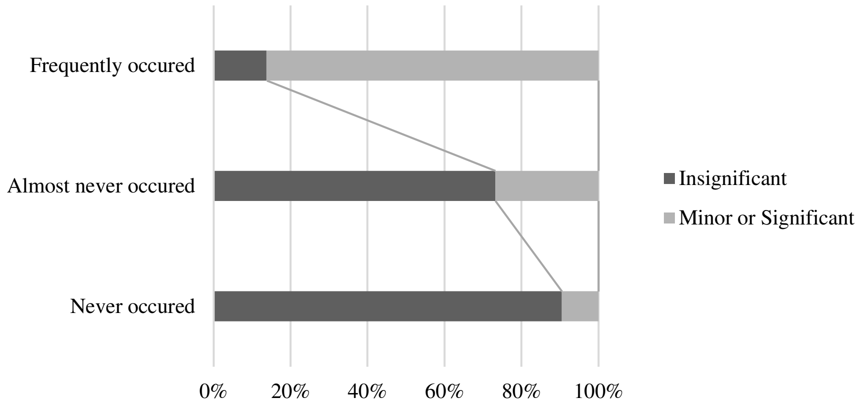

Figure 3. Answers to Question: "*Can IFRS themselves effectively prevent misstatement occurrence in the accounting?*"

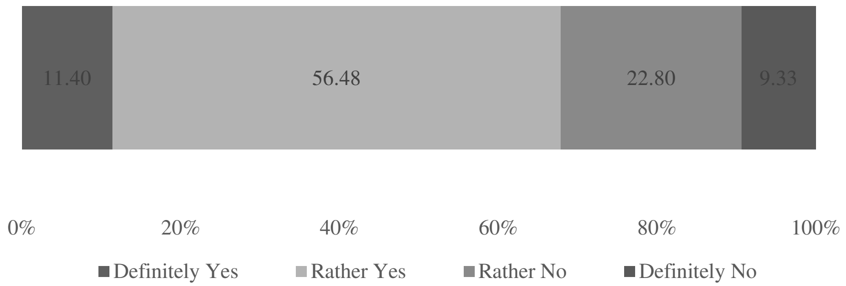

Figure 4. Answers to Question: "*Can the complexity of the IFRS application be the source of misstatements?*"

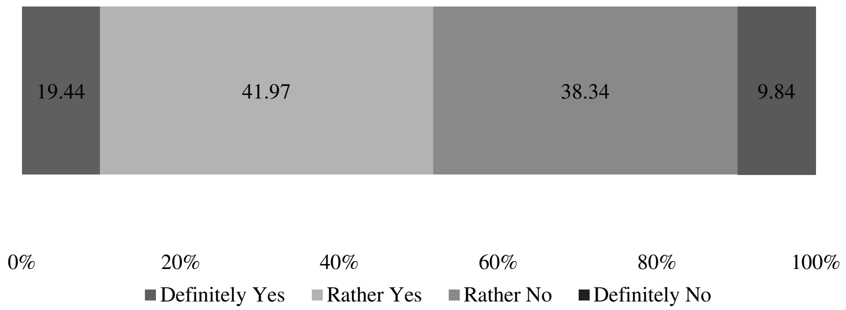

Figure 5. The willingness of accountants to manipulate the financial statements in response to management pressure to manipulate them