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Maja Zaman Groff

Meta Duhovnik

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# CORPORATE FINANCIAL REPORTING IN SLOVENIA: HISTORICAL DEVELOPMENT, CONTEMPORARY CHALLENGES AND POLICY IMPLICATIONS

MAJA ZAMAN GROFF<sup>1</sup>  
METKA DUHOVNIK<sup>2</sup>

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**ABSTRACT:** *Slovenia historically belongs to the continental legal system but has built its corporate financial reporting framework on the principles of measurement and recognition primarily derived from the Anglo-American system. The aim of the article is to present the development of the accounting practice in the transition period in Slovenia and to critically assess the current corporate financial reporting framework in Slovenia. Contingency approach, recognising that best solutions are dependent upon broader setting and that solutions that are effective in one country can be inappropriate in others, is used in the assessment of the current corporate financial reporting framework. The article highlights the challenges related to corporate financial reporting in the context of the Slovenian under developed capital market and deficiencies stemming from the discrepancies between legal and financial reporting frameworks. Although the new Slovenian Accounting Standards 2016 are expected to resolve some of the exposed problematic areas and increase transparency of financial reporting, additional regulatory changes in the field of accounting that are needed to further contribute to corporate financial reporting quality in Slovenia are pointed out.*

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**Keywords:** *accounting history; corporate financial reporting; accounting profession; policy implications; Slovenia*

**JEL Classification:** M41, M42, M48

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## 1. INTRODUCTION

Slovenia declared independence from Yugoslavia in June 1991. This represents the most notable milestone regarding the characteristics of its business environment, provoking fast and thorough changes in regulation, institutional setting and ownership of organizations. Transformation of the former (relatively market-oriented) socialist economy into an open market economy was characterized by the efforts of Slovenian companies to mitigate the declining revenues caused by the loss of the Yugoslav market by entering on a larger scale the highly competitive Western markets (Boduszyński, 2010).

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<sup>1</sup> University of Ljubljana, Faculty of Economics, Ljubljana, Slovenina, e-mail: maja.zaman@ef.uni-lj.si

<sup>2</sup> Metka Duhovnik passed away after a difficult illness in May 2017. In Slovenia and internationally, she significantly contributed to development of auditing profession. She was also a dedicated researcher. We are thankful for the privilege of having worked with her over many years.

Although the Slovenian economy successfully completed the transition to a market economy, the rise of unemployment was remarkable and companies often had to sell at or below marginal cost (Zapp, 1996) to gain business in highly competitive market economies. Social ownership of organizations, overstaffing and low productivity, all remnants of the previous socialist regime, resulted in lack of competitiveness and called for explicit regulatory changes. Slovenia opted for a decentralized mass privatization, a strategy which led to lower levels of foreign direct investments as compared to other countries in the region (Invest Slovenia, 2016).

Unlike privatization, regulation related to taxation and company law was developed centrally, drawing on established models from market economies (Garrod & Turk, 1995). Regulatory requirements post-independence have been predominantly based on continental European practice, a logical choice considering tight historical ties with Austria and the increasing importance of Germany for the Slovenian economy.

In spite of the many differences between socialist and developed Western economies, even before independence the Slovenian accounting profession as part of the Yugoslav profession was relatively advanced and independent. The leading professional organization, The Association of Accountants, Treasurers and Auditors (previously known as the Slovenian Society of Bookkeepers), was founded in 1957. As early as 1965, along with the Association of Economists it had initiated regular annual symposia “*with the intention of disseminating modern Western accounting concepts and approaches to Slovene practitioners*” (Garrod & Turk, 1995, p. 754). What is more, two years before Slovenian independence the Yugoslav Law on Accountancy (1989) had indicated movement towards harmonization with the EC Fourth Council Directive 78/660/EEC and called for the preparation of a set of domestic accounting standards in line with international norms. Notwithstanding the general orientation towards internationally viable accounting solutions some peculiarities of the former regime inevitably influenced corporate financial reporting. These were related to social ownership of companies (the concept of socially-owned capital differed from the established term in private firms), high independence of individual companies (consolidation procedures were not established), high incidence of workforce benefits, often at the cost of efficiency (high levels of non-business assets such as vacation properties offered to workers) etc. Moreover, the characteristics of the hyperinflationary environment just before Slovenian independence resulted in mandatory revaluation procedures, which were a very practical solution, but the resulting high levels of revaluation reserves were often regarded as peculiarities of the former regime. Considering the IAS 29 (*Financial Reporting in Hyperinflationary Economies*) issued in July 1989 that required the financial statements of an entity with a hyperinflationary functional currency to be restated for the changes in the general pricing power, this solution was, at the time, actually a modern accounting solution.

The years immediately following independence saw extensive legislation as well as sustained economic reforms in Slovenia. Moreover, the Slovenian Accounting Standards Committee, nominated by the newly established Slovenian Institute of Auditors, prepared the first Slovenian Accounting Standards (thirty core standards and an additional two

standards for banks and insurance companies, respectively) that were issued in April 1993. In line with the pre-independence developments in the accounting profession, the Slovenian Accounting Standards Committee managed to incorporate both developed domestic theory as well as international expertise – from the UK and US in particular – in the new standards, an important aim of which was to prevent state intervention in the accounting profession (Turk, 2012). The requirement to use accounting standards was incorporated into the newly adopted Companies Act (1993) and the need for a separate Law on Accountancy, previously representing core regulation in the field, no longer existed.

In short, global and local business environments have been changing rapidly during the 25 years of Slovenian independence. The changes are reflected in amended legislation, regulation and professional standards but historical traits also continue to impact the Slovenian corporate financial reporting practices.

The aim of the article is to present the development of the accounting practice in the transition period in Slovenia and to critically assess the current corporate financial reporting framework in Slovenia. We pinpoint some contemporary challenges identified in the field of corporate financial reporting in Slovenia and question to what extent the historical development of the Slovenian corporate financial reporting framework has led to an effective and efficient system. In the context of the contingency theory, recognising that best solutions are dependent upon broader settings, we support the idea that the particular characteristics of Slovenia and the wish to ‘conform’ with externally imposed regulations has led to a sub-optimal system that neither fits the local environment in Slovenia, nor achieves the objective of the Slovenian audit profession to be outward-looking and progressive. As a consequence, we discuss whether the already accepted changes in accordance with the European Accounting Directive 2013/34/EU are bringing any improvements in the field of corporate financial reporting.

The paper is structured as follows. To provide the framework of current corporate financial reporting in Slovenia, we first present the development of the accounting profession in Slovenia, the process of the gradual harmonization of the Slovenian Accounting Standards (SAS) with International Financial Reporting Standards (IFRS) and the application of the IFRS in Slovenia. Next, we identify some notable contemporary corporate financial reporting deficiencies in Slovenia and discuss their consequences for presentation of financial statements. The final discussion highlights the problematic regulatory areas in the field and suggests some viable regulatory changes that are still needed in the current context.

## **2. DEVELOPMENT OF THE ACCOUNTING PROFESSION AND ACCOUNTING STANDARDS IN SLOVENIA**

The accounting profession in Slovenia was originally organized by the Slovenian Society of Bookkeepers, established in Ljubljana in December 1957. In its early years the Society

comprised 3,000 members (Society of Accountants, Treasurers and Auditors: History, 2016), mainly bookkeepers and preparers of financial reports. The core accounting activities at the time of its founding were recording business transactions, and preparing yearly income statements and end-of-year balance sheets. Although professional societies were organized separately in each of the Yugoslav republics (Garrod & Turk, 1995), close co-operation and co-organization of professional events was intended to develop new knowledge and spread best practice throughout the profession. In addition to the Slovenian Society of Bookkeepers, the Slovenian Society of Economists played an important role in introducing modern Western accounting concepts to the developing Slovenian accounting profession. In 1965 it initiated the yearly symposia on contemporary methods in accounting, outlining new developments (both domestic and international) in accounting. These symposia, which were renowned for high quality contributions and wide practitioner participation, were also organized by professional societies in other Yugoslav republics. However, the role played by the Society of Economists as a co-organizer of symposia in Slovenia demonstrates the general Slovenian preference for considering economic implications along with the technical aspects and a receptiveness to contemporary developments from Western economies (Garrod & Turk, 1995).

The high level of independence and commitment to professional development were further reflected by the adoption of an independent Code of Accounting Principles in 1974, presenting the theoretical concepts of Slovenian accounting. The aim of the Code was to provide professional guidance and to set up a foundation for future development of more specific accounting rules in the form of accounting standards. In 1988, at the annual conference of the Yugoslav Association of Accountants and Treasurers, professor Turk underlined the need to upgrade the code. He advocated the formulation of national accounting standards with more specific accounting rules to guide and standardize accounting practices beyond accounting principles, incorporating the methods of recording and processing accounting data, preparation of financial statements and maintenance of accounting data and financial information (Turk, 2012). The profession followed the indicated direction in the wake of Slovenian independence in 1991 when the question regarding the future accounting framework called for an immediate response. One option was to follow the previous model where accounting practice was comprehensively prescribed by regulation and legislation in the field. The Slovenian accounting profession, following the direction set at the annual conference of the Yugoslav Association of Accountants and Treasurers in 1988, opted for the second option, the development and implementation of national accounting standards. This choice enabled the profession to incorporate the emergent domestic theory along with the established international accounting concepts into the new Slovenian Accounting Standards (SAS).

The first set of SAS 1993 included some characteristics of both the continental and the Anglo-American model. Although the basis of standard setting was closer to the Anglo-American model, emphasizing primarily shareholders' interests, the prudence principle embedded in the SAS 1993 reflected the continental approach, where shareholders are seen as a constituency of stakeholders among others, therefore emphasizing also the aspect of creditors, suppliers, customers, employees, government and the public. A total of

32 standards were issued in April 1993 and adopted in 1994. The standards were based on the drafts of the Yugoslav standards (Jerman & Novak, 2014) that were finalized in 1992 but never adopted due to, inter alia, very high levels of inflation (Turk, 2012). In addition to higher quality of accounting information, the expectation was that the preparation of national accounting standards would further reduce state involvement in the accounting profession (Garrod & Turk, 1995). While financial statements for 1993 were presented in line with existing Yugoslav regulation that remained effective at the time, the SAS were adopted on January 1, 1994 along with the new Slovenian Companies Act (at that time known as the Law on Commercial Companies) of 1993 which was highly influenced by the German and Austrian corporate law model. The new framework of corporate financial reporting, based on national accounting standards, significantly transformed the traditional (socialist) perception of the role of accounting and financial information. The major changes introduced by the SAS 1993 included the following (Turk, 2012, p. 181):

- accounting information was now required to present a fair view (presentation of accounting information was previously dominated by lawfulness),
- new solutions were directed to business needs and were no longer as tightly related to tax legislation,
- a broader stakeholder approach was adopted by stricter control over management, including financial statements auditing,
- the requirement to disclose all relevant information regarding financial position and net income reduced the incidence of hidden reserves,
- to ensure that accounting information gave a relevant and accurate presentation of transactions, the accounting principle of substance over form was implemented,
- the SAS were prepared by the accounting profession and replaced numerous acts and regulations that were previously highly influenced by political interests,
- in addition to the business aspect, reflected in the balance sheet and the income statement, the SAS also emphasized the financial aspect by introducing the statement of changes in financial position,
- accounting solutions were no longer focused only on processing historical data; book-keeping, the previous focus of accounting function, was supplemented by solutions in the field of budgeting and financial analysis.

Following the initial SAS adoption in Slovenia the business environment continued to change rapidly and involved processes of privatization, internationalization and the beginning of the EU accession process. An increasingly competitive global environment, the requirement to start the harmonization process and the desire of the accounting profession to keep pace with the international accounting developments and best practices called for the revision of the 1993 SAS. The new standards were issued in 2001 and first used in 2002, following the adoption of the new Companies Act of 2002, which was based on the *acquis communautaire* and the German legal tradition (World Bank, 2004). It required all companies to apply SAS in their consolidated and legal entity financial statements but it did not require public interest entities to prepare financial statements in conformity with the IFRS. The amended SAS 2001 retained the established structure and their scope was broader than the IFRS in the sense that they outlined accounting

procedures regarding budgeting, financial analysis and other aspects of accounting function in addition to external corporate reporting (Turk, 2012). The major shift introduced by the SAS 2001 was related to the valuation of assets and liabilities emphasizing their true and fair presentation. To implement the valuation-related accounting practices already incorporated in the IFRS, the fair value principle as a typical Anglo-American accounting concept was introduced to measure individual balance sheet items. Although the changes in SAS 2001 were considered to be a massive step towards harmonization with IFRS (Jermań & Novak, 2014), the World Bank (2004) pointed out some fundamental differences remaining between the SAS 2001 and IFRS: capitalization of foreign exchange losses, broader definition of extraordinary items, capitalization of start-up costs, treasury stock recorded as investment and long-term receivables recorded as current assets.

In the following years, the preparation for Slovenia's accession to the European Union on May 1, 2004 was dominated by the processes of harmonization of the national legislation with the EU legal framework. In the field of accounting, the most important EU legislation that had to be adopted included the Fourth Council Directive 78/660/EEC on the annual accounts of certain types of companies, the Seventh Council Directive 83/349/EEC on consolidated accounts and Regulation (EC) 1606/2002 on the application of international accounting standards. According to Article 4 of Regulation 1606/2002 all companies governed by the law of any member state were required to prepare their consolidated accounts in conformity with the international accounting standards if their securities were traded on a regulated market of any member state, for each financial year starting on or after January 1, 2005. To adopt the aforementioned EU legislation into the Slovenian legal framework, Article 54 of the amended Companies Act of 2006 required that the new SAS must incorporate the content of Directive 78/660/EEC and Directive 83/349/EEC (the EU accounting directives) and their concept must not conflict with the International Financial Reporting Standards. Moreover, the Companies Act introduced the requirement for all companies whose securities were traded on any EU regulated market to prepare their consolidated financial statements in conformity with the IFRS. The use of the IFRS was optional for all other companies if so decided by the company's annual general meeting, for a minimum period of five years. In line with the Regulation 1606/2002 on the application of international accounting standards the IFRS also became mandatory for preparation of financial statements of banks and insurance companies whose securities were traded on any EU regulated market. This provision was shortly followed by the requirements of the Bank of Slovenia and the Slovenian Insurance Supervision Agency, calling for mandatory use of the IFRS also for the annual (individual) financial statements of banks (starting in year 2006) and insurance companies (from year 2007).

To achieve the required high level of harmonization with the IFRS the new SAS 2006 were adopted. The most notable amendments introduced by the SAS 2006 related to the field of property, plant and equipment as well as intangible assets<sup>3</sup>, investment property<sup>4</sup>,

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3 For measurement after recognition a company could use either cost or revaluation model.

4 Separate accounting treatment of investment property was introduced and the option was given to use the fair value model for measurement after recognition.

financial assets<sup>5</sup> and loans and receivables<sup>6</sup>, along with some additional changes in the financial statements (Novak, 2008). Despite the high level of harmonization of SAS 2006 with the IFRS the national standards retained the original structure.

In its relatively short history Slovenia's progress in the development of high quality accounting standards and their harmonization with the IFRS has been evident. As international financial reporting practice has developed, there have been additional pressures and challenges to delivering relevant, internationally aligned, accounting regulation. This has raised tensions between the corporate legal framework of German origin and the financial reporting framework of Anglo-American origin. It has also given rise to implementation problems caused by technical deficiencies of prepares of financial statements, and their limited experience of new concepts.

### 3. CHALLENGES RELATED TO THE SLOVENIAN CORPORATE FINANCIAL REPORTING FRAMEWORK

Since Slovenian independence the corporate financial reporting framework of Slovenian companies has been determined by the Companies Act. According to this act companies are obliged to prepare financial statements either on the basis of the SAS (that are highly harmonized with the IFRS) or by direct use of the IFRS as adopted by the EU. In the following paragraphs we will try to support or reject the suitability of legally offering all companies the possibility to use IFRS.

The World Bank Centre for Financial Reporting Reform (2011) outlined that the mandatory use of the IFRS in the EU is intended for the preparation of consolidated accounts of publicly traded companies whose securities are traded on a regulated market in the European Union. The term 'regulated market', which is important in the regulatory context, is defined in Article 4 of Directive 2004/39/EC on markets in financial instruments as the authorized multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments and functions regularly.

Under the subsidiary principle Regulation 1606/2002 authorized the member states to allow or require other companies and groups to prepare separate or consolidated accounts in accordance with the IFRS. The latest publicly available data (Overview of the use of options provided in the IAS Regulation, 2013) reveal that very few EU countries (Bulgaria, Cyprus, Estonia, Ireland, Luxemburg, Malta, Slovenia and the UK) permit the use of IFRS to all companies regardless their size and activity.

Many influential European countries with developed market economies (France, Germany, Spain and Sweden) were much more resistant to the general IFRS adoption. This can be

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<sup>5</sup> The four categories of financial assets had to be introduced in line with the IFRS.

<sup>6</sup> Amendments were related to different accounting treatments for measurement after recognition.



explained by the fact that the IFRS are intended to serve the particular financial reporting needs of large companies with public accountability. However, in the Basis for Conclusions related to the International Financial Reporting Standard for Small and Medium sized Entities (IFRS for SMEs) even the International Accounting Standards Board (IASB) recognized that the circumstances of SMEs can be different from those of large publicly accountable companies. The differences include different users of financial statements and their information needs, the way the financial statements are used, the accounting knowledge and experiences that is available to the entity and the financial ability to cover the cost of rather extensive requirements of the IFRS (International Accounting Standards Board, 2009). On the basis of this we can conclude that the option to offer all companies the possibility of using IFRS might not have been as judicious as expected by the legislative bodies.

In Slovenia the development of the SAS can be described as a gradual approach to the IFRS. It started with the prudence principle (SAS 1993), continued with moderate fair valuation (SAS 2001) through to almost complete adjustment to IFRS (SAS 2006). The problem related to the adjustment of SAS to the IFRS is that technically the SAS became 'small IFRS' in the sense that they are not as detailed, and do not include similar explanatory materials intended to enhance understanding and proper use of accounting concepts. Nevertheless, the requirements for recognition, valuation and measurement of financial statement items are as demanding as those of the IFRS. Because in companies using SAS the requirements and explanatory materials of the IFRS cannot be used directly, and considering the relatively less developed market environment, some questions regarding the appropriate accounting treatment cannot be adequately answered by the SAS nor by the IFRS. As stated in the SAS 2006 the companies that are obliged to comply with the SAS shall directly apply only the provisions of the IFRS to which the SAS directly refer. Other provisions of the IFRS cannot directly be construed as provisions of the SAS. Pending their integration into the SAS, or the adoption of a relevant interpretation from the Slovenian Institute of Auditors, such IFRS can only be construed as information about professional practice. At this point it has to be stressed that the direct use of individual IFRS requirements might be problematic if the user is not acquainted with the context of the IFRS as a whole. The individual requirement, taken out of context might be misunderstood and misused.

The concept of materiality in SAS 2006 is a viable example of insufficient guidance and explanatory materials for preparers of financial statements. Companies using SAS often do not understand the concept of materiality at the financial statement level. Although the SAS define that information is material if its omission or misrepresentation could influence the economic decisions of users taken on the basis of financial statements, such a definition does not provide the appropriate understanding to the SAS users. Consequently, materiality-related internal rules, prepared by companies using SAS, are often unreasonable; for example their internal rules may state that equipment is considered material if it represents more than 10% of total plant and equipment. Such determination of materiality for each individual financial statement item prevents the management's accurate estimation of materiality at the financial statement level. Lack of materiality-

related guidance is also reflected in additional efforts to calculate deferred taxes, deferred compensations for redundancy and similar. While these inevitably increase the workload and related cost, they might be completely immaterial by substance and size and therefore omitted.

The highly concentrated substance of SAS requirements also causes legal lacunae<sup>7</sup> in different areas of SAS and thus difficulties for preparers as well as financial statements auditors. Since IFRS pronouncements are not part of SAS, the innovative solutions presented in the SAS compliant financial statements cannot be effectively challenged by auditors without appropriate legal basis. In the absence of an active market the consequence is an array of different measurements and valuations of the same phenomena in financial statements of different companies, causing decreased information value of such information for financial statements users (especially creditors). From the annual reports published by the Slovenian Institute of Auditors<sup>8</sup> and the Agency for Public Oversight of Auditing<sup>9</sup> it is evident that inappropriate input data and inappropriate use of valuation methods are among the most frequent violations of International Standards on Auditing used in Slovenia.

The external quality control of the Slovenian auditing firms in the last few years has demonstrated that the most frequent problems are related to fair valuation of individual financial statement items especially property, plant and equipment, intangibles, investment property, financial investments and derivatives (Annual report of the Slovenian Institute of Auditors, 2014; Annual report of the Slovenian Agency for Public Oversight of Auditing, 2014). For this reason we illustrate the legal lacunae in SAS for the case of fair valuation.

Fair value of various balance sheet items in SAS (2006) is defined as follows:

- Fair value is the amount for which the asset could be exchanged, or a liability settled, or a granted equity instrument exchanged between knowledgeable and willing parties in an arm's length transaction (general definition in the Introduction to SAS).
- The fair value of land and buildings and also of plant and equipment is usually determined on the basis of marked-based evidence by appraisal normally undertaken by certified appraisers in accordance with the International Valuation Standards (SAS 1.27).
- Intangible assets may be revalued to fair value if there is an active market for the assets (SAS 2.30)
- Fair value is evidenced if it can be reliably measured. Fair value is reliably measurable if there is:
  - a) a quoted market price in an active securities market; or
  - b) a valuation technique which incorporates data inputs taken from the active market. (SAS 3.21 referring to financial investments.)

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<sup>7</sup> For the purposes of this paper the term legal lacunae is defined as imprecisely defined legal requirements.

<sup>8</sup> <http://si-revizija.si/oinstitutu/porocila-o-delu>

<sup>9</sup> [http://www.anr.si/Porocanje\\_Agencije](http://www.anr.si/Porocanje_Agencije)

- The fair value of an investment property is measured on the basis of market value at the balance sheet date, usually determined by certified appraisers in accordance with the International Valuation Standards (SAS 6.13).

The presented provisions of SAS reveal that the ability to determine fair value depends on the existence of an active market granting either the price or the input data for the valuation model. At the same time, the SAS do not specify what kind of valuation model is acceptable. In the case of direct interpretation of the provision it is sufficient that an active market exists. It is left to the certified appraiser to decide which model is appropriate in the given circumstances according to the International Valuation Standards (IVS, 2013). The section of the IVS that specifies the valuation rules for accounting purposes refers to various requirements of IFRS, especially IFRS 13 (Commission Regulation (EU) No 1255/2012), and not to national accounting standards. This means that the IVS can properly be used if the financial reporting framework is IFRS, or at least very similar to IFRS in the sense of extensive fair valuation requirements ranking the quality of fair valuation according to the reliability of the available input data as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are unobservable inputs for the asset or liability.

Comparing IFRS (Regulation (EC) No 1606/2002) and SAS (2006) it is quickly apparent that the requirements and guidance related to fair valuation and measurement are much more detailed in IFRS than in SAS. In an environment with a considerably less developed financial market this gives rise to different and usually creative approaches of valuing assets for accounting purposes. The World Economic Forum has recently presented the Competitiveness Report 2015-16. The ranking of the financial market development places Slovenia as low as 128<sup>th</sup> out of 140 countries (World Economic Forum, 2016), which implies that the mentioned fair value related issues are highly relevant. Considering that the valuation model used gives better results the closer the period and environment in which it was developed, the model used, for example the Capital Asset Pricing Model, can often be rendered inappropriate (Pustoslemšek, Slapničar & Valentinčič, 2016) and/or assumptions connected with its use unrealistic (Duhovnik, 2007).

As contemporary financial reporting frameworks such as IFRS rise from an environment with relatively high market efficiency, small economies like Slovenia are faced with a certain paradox. "Since their capital markets are less efficient than the developed capital markets with a long historical tradition, the need to establish fair value by using a valuation technique is more frequent. But the domestic market does not offer adequate market inputs for valuation models. The use of data from developed capital markets requires better skills of appraisers valuing the business, although the level of general knowledge in a small economy is different from a country with a long-term market tradition" (Duhovnik, 2007, p.77). The problem can also be observed from the other perspective by asking whether

the need to establish fair value by using a valuation technique under IFRS really exists even though there are no appropriate market data available (compare with Nobes, 2015). Although the answer to this question is clear according to the IFRS, in the national environment it is often left to the discretion of preparers of the financial statements and their advisers due to the lack of relevant provisions in national standards.

In the circumstances described statutory auditors that audit financial statements containing categories measured at fair value are in a rather unenviable position. Although they may consider that the estimated value is far from being fair, no legal basis is available to support their opinion. Carrying out professional judgment in the young Slovenian audit profession is therefore much more challenging as compared to the mature profession in well-developed market economies. This can give rise to higher audit risk that can consequently result in a lower degree of confidence on the part of intended users of the audited financial statements.

#### 4. CHALLENGES RELATED TO DISCREPANCIES BETWEEN LEGAL AND FINANCIAL REPORTING FRAMEWORKS

At the national level, a financial reporting system should enable the country to trace the allocation of resources and optimally apportion goods and services. The method of allocation (economic system) is strongly influenced by the legislation (legal system), determined by the people in power (political system). Collectively, the three systems affect the external financial reporting requirements. Historically, legal systems can be divided into *civil law* based on Roman law, and *common law* (also known as *case law*) referring to precedents or rules established in previous legal cases.

As explained by The Economist (What is the difference between common and civil law, 2013) the difference between common and civil legal traditions lies in their main source. Although common law systems make extensive use of statutes, judicial cases are regarded as the most important source of law. This approach gives judges and courts an active role in developing rules. To ensure consistency, the courts abide by precedents set by higher courts, deciding cases on the same issues. In civil-law systems, by contrast, codes and statutes are designed to cover all eventualities, and judges and courts have a more limited role of applying the law to the case in hand. Past judgments play a secondary role in the sense of loose guides. In court cases, the judges in civil law systems tend towards being investigators, while their peers in common law systems act as arbiters between parties that present their arguments. Civil law systems are more widespread than common law systems: the CIA World Factbook reports the numbers at 150 and 80 countries, respectively (What is the difference between common and civil law, 2013). Common law systems prevail in the UK and the former British colonies and countries that have been influenced by the Anglo-American tradition, such as Australia, India, Canada and the United States.

The main effect of the two legal systems on general principles of their respective financial reporting and selected recognition and valuation rules are illustrated in Table 1.

**Table 1.** The effect of the main environmental factors on financial reporting

<b>Financial reporting</b>	
<b>Anglo-American</b>	<b>Continental</b>
<b>General principles of financial reporting<sup>1</sup></b>	
- fairness	- legal basis
- disclosure	- confidentiality
- independence of tax rules	- strong connection to tax rules
- professional behaviour over legal form	- legal form over professional behaviour
- professional standards of financial reporting	- legal rules (law, pronouncements etc.)
<b>Selected recognition and valuation rules<sup>2</sup></b>	
- relatively large number of accounting options allowed, encouraged professional reasoning	- limited number of accounting options allowed
- principle of prudence implementation – not explicitly required	- principle of prudence implementation – explicitly required
- fair value use very important	- historical cost and fair value

Source: <sup>1</sup>Hayn, 1997, p. 43.

<sup>2</sup>Deaconu & Buiga, 2011, p. 140.

With the adoption of Regulation 1606/2002 on the application of international accounting standards and gradual endorsement of individual IFRSs inside the EU, the principles of measurement and recognition deriving from the Anglo-American background became part of the European legislation. They supplemented the continental environment originated prudence principles in the Fourth and the Seventh Directives to enable the use of the fair value principle in certain circumstances.

Although recent decades reflect a constant tendency towards international harmonization of financial reporting these trends still indicate that different legal environments and other historical, developmental, environmental and political factors should be taken into account when deciding on the optimal corporate reporting requirements in a given national setting (compare with Lourenço et al., 2015). Slovenia historically belongs to the continental legal system and is still under the very strong influence of German and Austrian legislation. The majority of provisions in the Companies Act have German or Austrian origin. On the other hand Slovenian accounting requirements are based on common law Anglo-American principles. The way in which historical, developmental and environmental factors have been taken into account when incorporating such legal requirements was left to decision making structures with limited market economy experience.

During the privatization process, starting in 1993, a total of approximately 1,500 Slovenian companies with social capital were privatized. 140 of these were selling shares to the public and were subsequently listed on the Ljubljana Stock Exchange, established at the

end of 1989 (Duhovnik, 2007). Due to a strong tradition of self-management and soft financial conditions for management and employee buyouts, the privatization process led to a high percentage of insider ownership. Such ownership did not necessarily imply that each privatized company had a group of active private owners, able and willing to take the strategic choices needed to adapt to the changed environment and ensure continuous growth and efficiency. Consequently, a process of concentrating ownership in the hands of active owners was inevitable. The companies with concentrated ownership predominantly withdrew from the stock exchange; by the end of 2007 the number of listed companies had decreased to around 100.

In spite of the convincing motivation to transfer continental corporate legislation from developed economies with a strong market tradition into the Slovenian environment, its implementation was incomplete, especially as regards implementation and enforcement of penal provisions. Evidenced by the rather poor level of corporate ethics in the Slovenian private sector - 82<sup>nd</sup> place among 140 countries (World Economic Forum, 2015-2016) - the lack of relevant penal provisions and/or their enforcement resulted in a situation where core business priorities were recurrently replaced by managements' activities in ownership concentration. This practice was reflected in increased indebtedness of Slovenian companies after the start of the privatization process until the start of the financial crisis in Slovenia in 2009. Table 2 reveals a sharp drop of capital/total assets ratio of Slovenian commercial companies from 1992 (64.2%) to 2008 (34.8%), brought to an end in 2009 when due to the start of the financial crisis the banking sector started to refrain from assigning or extending loans to poorly performing, non performing and/or heavily indebted companies. In conditions of efficient management and strong corporate governance increasing indebtedness should result in enhanced corporate performance. However, comparing the level of indebtedness with the net income/sales ratio of Slovenian commercial companies it appears that the growing indebtedness of the Slovenian economy before the financial crisis had no positive impact on sales needed for further sustained growth.

**Table 2.** Rates of indebtedness and returns on sales of Slovenian commercial companies for years 1992, 1996 and 2007 – 2014

Year	1992	1996	2007	2008	2009	2010	2011	2012	2013	2014
<b>Capital/Total assets (%)</b>	64.2	54.6	37.0	34.8	35.1	37.8	38.1	38.8	40.0	41.9
<b>Net income/Sales (%)</b>	n/a	n/a	4.4	1.9	0.8	-0.3	0.6	0.4	0.2	1.1

Source: AJPES (1993, 2012, 2015a, 2016)

As accounting policies and practices (especially different approaches used for fair valuation and diverse criteria for impairment of assets) enabled many companies to choose extremely optimistic options for presentation of their financial position, the levels of indebtedness continued to rise in spite of the lack of economic arguments. Considering the aforementioned lack of any legal basis to reject the auditee's selection of fair valuation

it is not surprising that quite a few companies<sup>10</sup> that are in the process of bankruptcy had received no going concern modification of audit opinion in the years before bankruptcy (Pikelj & Slapničar, 2014). It is highly plausible that such practice would not have been observed in an environment with high levels of business ethics, efficiency of corporate governance and effectiveness of the judicial system. The Competitiveness Rankings of the World Economic Forum offers some corroborating evidence for the aforementioned observations. The Slovenian ranking (among 140 countries) is weak in the fields of strength of auditing and reporting standards (87<sup>th</sup> place), efficacy of corporate boards (110<sup>th</sup> place), protection of minority shareholders' interests (121<sup>st</sup> place), judicial independence (85<sup>th</sup> place) and efficiency of legal framework in settling disputes (115<sup>th</sup> place) (World Economic Forum 2015-2016).

## 5. DISCUSSION AND POLICY IMPLICATIONS

The Auditing Council of the Slovenian Institute of Auditors, as the leading professional institution in accounting and auditing profession, took an active role in the public discussion related to the implementation of Accounting Directive 2013/34/EU into the Slovenian Companies Act. Its principal aim was to enhance the implementation of requirements that would improve the true and fair view of the financial statements of Slovenian companies, considering its less efficient capital market environment. Most notably, in a letter to the Ministry of the Economic Development and Technology in 2013, it proposed to narrow the option of fair valuation as it was reasonable to expect that such provision would have a positive effect on the risk of financial statements being materially misstated (Slovenian Institute of Auditors – Auditing Council, 2013). More specifically, the proposal supported the following solutions:

- Only listed companies, obliged to prepare consolidated accounts, banks and insurance companies, should be obliged to use IFRS.
- The option to use IFRS should be given to other listed companies and companies incorporated in groups with parent companies using IFRS.
- All other companies should use national accounting standards (SAS) that should be prepared in line with the Accounting Directive 2013/34/EU incorporating the prudence principle. The items recognised in financial statements should therefore be measured in accordance with the principle of purchase price or production cost to ensure reliability of financial statement information. Financial instruments quoted on the active market, which should be measured at fair (market) value, represent an exemption to the aforementioned rule. It was argued that the proposed solution would prevent usage of valuation models that, in the majority of cases, do not fit the circumstances and consequently do not result in true and fair presentation. Regarding new SAS the proposal included some simplifications, including simplifications related to deferred taxes, which were often subject to different professional interpretations and did not improve the information value of financial statements.

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10 Some viable examples include Avto Celje d.d. - v stečajju, Merkur d.d. - v stečajju, Peko d.d. - v stečajju (retrieved from AJPES database).

As regards statutory auditing, the Auditing Council proposed the implementation of size thresholds as stated in the Accounting Directive 2013/34/EU. In addition, to improve the quality of financial statements prepared for smaller companies by service organizations (as these are often not qualified to properly understand and use the financial reporting framework) it called for a requirement that the small (not micro) companies using service organizations for preparation of financial statements should submit a compilation report.

To incorporate the Accounting Directive 2013/34/EU, particularly the changes related to the balance law, into Slovenian national legislation the Companies Act was amended in 2015. The changes in accounting represented the major part of the amendments. As before, the amended Companies Act still governs only fundamental balance law questions by determining fundamental rules regarding the drawing up of the annual report and financial accounts, while leaving the details to the SAS (Kocbek, 2015). Although the most notable changes in the Accounting Directive are related to the valuation of financial statements items with an emphasis on historical cost valuation while measurement at revalued amount or at fair value is treated as an allowed alternative (Kocbek, 2015), this is not clearly reflected in the implemented amendments of the Companies Act. Equally, the IFRS limitation proposed by the Auditing Council was not accepted; the option for all the companies to prepare financial statements in line with the IFRS was retained. The proposed compilation report was not endorsed.

On the other hand, some innovations regarding corporate reporting were incorporated in the Companies Act. With the aim of better protecting minority shareholders' interests the presentation of an extended report on transactions with related companies is now required. Although the idea was taken from German law it is evident that in Germany this report is an obligation of public liability companies only (HFA 3/1991) while the Slovenian Companies Act also requires the report from audited limited liability companies. For a limited liability company with a single owner-manager the additional reporting causes an additional administrative burden without appropriate positive effects.

On the basis of the amended Companies Act the accounting profession has issued the new SAS 2016, applicable for financial statements for periods starting on January 1, 2016 or later. Although the proposal of the Auditing Council to avoid the use of valuation models in the process of fair valuation was not accepted, the new SAS, prescribing much more detailed (market oriented) rules for determining fair value, can be regarded as a step towards enhanced true and fair presentation. In addition to increasing the transparency of financial reporting the more detailed and market-oriented rules have at least partly resolved the discussed legal lacunae in the case of fair valuation. Additional benefits of the new SAS include simplification applicable to small and especially micro companies regarding the layout of annual accounts and the treatment of some other items, such as deferred taxes and compensations for pensions.

Notwithstanding the changes in the accounting field the professional judgment of auditors will still be challenged during the process of auditing. Whether the audit reform will bring the desired effects regarding audit quality remains to be seen. In any case, the auditors will



be faced with two different regimes – Regulation (EU) 537/2014, governing the statutory audits of public interest entities, and the national Auditing Act, harmonized with Directive 2014/56/EU, covering general aspects of the mandatory audit. Due to the small size of the Slovenian audit market with approximately 100 public interest entities (including listed companies, banks and insurance companies), 1,637 separate accounts and 477 consolidated accounts in 2014 (AJPES, 2015b) subject to mandatory audit, Slovenia has little scope to avoid the administrative burden related to the audit regulation. To make the implementation as efficient as possible it has to be very careful when choosing between the options put forward by the regulation.

However, to promote high audit quality as the main aim of the recent EU audit reform, emphasis should be placed on auditor independence. Decisions between different options in the field of provision of non-audit services and auditor rotation should be judged against their influence on auditor independence. Therefore, audit firms should be restrained from provision of any tax and valuation services for their audit clients unless such services have no material effects on the financial statements and the principle of independence is fully respected in line with the Directive 2014/56/EU. To avoid deviations from conditions for auditing parent companies abroad, it would be advisable to select the option of tendering to prolong audit tenure to more than ten years. This solution would prevent deterioration of competitiveness within the business environment and simultaneously enable governance structures (especially audit committees) to make informative decisions whether audit quality and independence of incumbent statutory auditor warrant the prolongation of audit engagement. Corruption and unethical behaviour would be minimized by the granting of full disclosure of data gathered in the audit process that indicates violation of law and regulation to the supervisors of public interest entities (Article 12). To avoid price competition deteriorating audit quality it would also be advised for the initial audit engagement to last more than one year (Article 17). Although some of the recommendations are already incorporated within the proposals for the amended Auditing Act, the final solutions are still unsure, but there is no doubt that all the provisions intended to increase audit quality will have a positive effect on true and fair financial reporting.

All in all it seems that currently Slovenian legislation is much more complex than appropriate in the given circumstances. The complexity can be misused by groups, politically and technically strong enough to follow their own interests through the array of generally accepted solutions. Therefore, the endeavours of policy makers when incorporating the European audit reform into Slovenian national legislation should not disregard the fact that simplicity makes things less risky. And when the legal system is unable to detect, correct and punish deviations on a timely basis, this is even more important.

## 6. CONCLUSION

Throughout its history, the Slovenian accounting profession has been receptive to contemporary developments of the accounting practices of developed economies. In this paper we have outlined the progress in development of high quality accounting standards

in Slovenia which can be described as a process of gradual approach to IFRS: starting with the prudence principle (SAS 1993) and continuing with moderate fair valuation (SAS 2001) the process has resulted in almost complete adjustment to the IFRS (SAS 2006).

Considering close historical ties with Austria, Slovenia historically belongs to the continental civil-law legal system. Although the prudence principle embedded in the first set of national accounting standards reflected this continental approach, the fair value principle as a typical accounting concept of Anglo-American common-law origin was introduced at the turn of the century. The effect of this shift in the Slovenian financial reporting framework was threefold. First, implementing the EU legal framework into the national legislation, it was part of the harmonization process and enabled Slovenia's accession to the EU. Second, in the context of a relatively underdeveloped capital market the new financial reporting framework posed some viable challenges to preparers, users and auditors of financial statements. These were predominantly related to legal lacunae in the field of fair valuation of individual financial statement items especially property, plant and equipment, intangibles, investment property, financial investments and derivatives. The resulting array of different options for measurement and valuation of individual balance sheet items decreased the information value of audited financial statements. And third, in the Slovenian civil law setting, the implementation of a viable Anglo- American accounting concept posed some challenges related to discrepancies between legal and financial reporting frameworks, especially as regards increasing indebtedness of Slovenian companies and implementation and enforcement of penal provisions.

Recently, Slovenia has incorporated the European Accounting Directive 2013/34/EU into its national legislation. Although some of the proposals that were aimed at resolving the discussed corporate financial reporting deficiencies (such as limitation of companies allowed to use IFRS) were not adopted, the new SAS 2016 prescribe more detailed rules for fair valuation, a measure intended to address the legal lacunae in the case of fair valuation and result in increased transparency of financial reporting. Moreover, simplifications applicable to small and micro firms (such as annual accounts layout, treatment of deferred taxes, compensations for pensions and annual leave) represent additional benefits of the new SAS. But since the SAS 2016 are applicable since January 1, 2016 or later more time is needed to establish whether or not the implemented changes are bringing the necessary improvements in the field of corporate financial reporting in Slovenia.

With the amended Companies Act 2015 and the new SAS 2016 a step forward has been made in adapting corporate financial reporting to the Slovenian legal and economic environment. However, given that the Slovenian legal framework has a continental origin it would be advisable to keep the Anglo-American accounting freedom under control by means similar to those used in Austria and Germany, particularly effective enforcement of sanctions for noncompliance. Moreover, on the basis of presented arguments we argue that the use of valuation models in Slovenia often does not fit the circumstances and consequently does not result in true and fair presentation. Although the most notable changes in the Accounting Directive are related to the valuation of financial statements items with an emphasis on historical cost valuation while measurement at revalued amount

or at fair value is treated as an allowed alternative (Kocbek, 2015), this is not clearly reflected in the implemented amendments of the Companies Act. Consequently, with the exception the financial instruments quoted on the active market (which should be measured at market value), we propose to narrow the option of fair valuation as it is reasonable to expect that such provision would decrease the risk of financial statements being materially misstated. The items recognised in financial statements should therefore be measured in accordance with the principle of purchase price or production cost to properly incorporate prudence principle and ensure reliability of financial statement information. Our analysis also revealed that very few EU countries permit the use of IFRS to all companies regardless their size and activity. Many EU countries with developed market economies are more resistant to general IFRS adoption, as use of IFRS is primarily intended for preparation of consolidated accounts of publicly traded companies. Since the circumstances of SMEs differ from publicly accountable companies in terms of financial statements users, their information needs and accounting knowledge, to list just a few, we believe that in Slovenia the use of IFRS should be restricted to public interest entities, companies incorporated in groups with parent companies using IFRS and for consolidation purposes.

Although some remarkable improvements have been made in the financial reporting framework on the basis of the European accounting reform there is still room for improvements seeking the balance between the ideal theoretical framework and requirements granting optimal results in a small economy. Considering that in Slovenia the majority (around 97%) of companies are small and micro companies (taking into account the thresholds from the Directive 2013/34/EU) and that the ranking of the financial market development is among the lowest (World Economic Forum, 2016) our analysis of the current corporate financial reporting framework exposed some of the problems that still need to be resolved in the given context.

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