

DOES EARNINGS MANAGEMENT CHANGE AFTER THE ADOPTION OF THE IFRS? EVIDENCE FROM ROMANIA

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Abstract

Once that International Financial Reporting Standards are used for individual financial reporting, we expect that companies are going to achieve an increase in the financial reporting due to a higher degree of transparency. The present research tries to emphasize if there is any significant difference between the value of earnings management computed by using the national and the international accounting measures. The research is conducted on Romanian capital market, into the listed companies. The results of the research are mixed. While an improvement in the variability of net profit is observed (both for individual and bootstrapping with replacement analysis), the correlation between accruals and cash flow from operation is more negative (using both estimations techniques). The results on the differences of cash flow from operations also show an increase in the value of earnings management.

Keywords: Financial performance, International Accounting regulation, Romanian Accounting Standards

JEL Classification: M41, G30

1. Introduction

Starting with 2012, the entities that are listed into the Bucharest Stock Exchange have to report their individual financial statements using the international regulation (International Financial Reporting Standards-IFRS). The requirement is mandatory and is based on 881/2012 Order and 1286/2012 Order of the Ministry of

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Finance (they emphasize the need to use the international framework instead of the national one). The new regulation repeals the 1121/2006 Order of the Ministry of Finance according to which the Romanian entities have to report their individual financial statements using both the national (Romanian Accounting Standards- RAS) and the international framework.

This regulation is in line with the regulations imposed for the financial institutions that Romanian banks have to use and it looks at IFRS development at national level. As a fact, the 15/2009 Order of the National Bank of Romania (NBR) enforced financial institutions to report their financial statement using the national and the international accounting framework (one set of financial statements was realized using RAS and another one was realized under IFRS). The entities have also to provide evidence about the difference between the two types of financial statements. According to the 9/2010 NBR order, starting with the beginning of the year 2012, the only accepted way of reporting the individual financial statements is under IFRS. There is also 27/2012 NBR order that considers that the accounting measures should be in accordance with the international regulation.

Regarding the adoption of the new accounting regulation, the literature in the filed provides mixed evidence on their influence on financial performance indicators. Considering these, the purpose of this research is to reveal if some elements that are related with financial performance suffer or not a change after the adoption of the International Financial Reporting Standards.

The rest of the paper is structured as follows: the first section refers to some issues found in the main literature about the switch from national accounting regulation to international accounting framework. The second section presents some information related with the database and the methodology of research, the third section presents an additional analysis considering the research that was conducted. The forth section provides evidence about the results of the research and reveals some discussions on them, while the last part is the part that refers to conclusions and future research activities.

2. Literature review

In the main literature there are various approaches on the impact that the switch from national accounting regulation to the international accounting framework has on financial performance of

an entity. Many studies look at the private gains that the managers can get. The results are mixed. On one hand, it is considered that the adoption of the new accounting regulation is going to create higher transparency in financial reporting and thus, the accounting information is going to be improved (Daske, 2006). On the other hand, some marginal differences can be detected as the characteristics of the region or of the country can significantly impact data comparability (CascinoșiGassen, 2014)

The issues related with the abnormal return- the private benefits that the financial managers can gain - look at the earnings management procedures that an entity can use. As a fact, the analysis focus on the fluctuations on net profit volatility, the fluctuations on cash flow from operations and the ratio of them (all measured by residual variance) and the correlation between the residuals of cash flow from operations and the residuals of accruals. Considering this, Barth et. al. (2008) think that the entities that adopt the IFRS as accounting measure for constructing their individual financial statements have lower levels of earnings management, recognize the losses on a longer period of time and the accounting elements have higher value relevance. The results are based on a comparison between the values computed using national accounting regulation and the values computed using the international accounting framework. Similar conclusions were detected by Dimitropoulos et. al (2013) for the Greek companies.

On the other hand, there are also research papers that provide evidence of a negative influence of the international accounting regulation on financial performance. Paglietti (2009) reveals that once the international accounting framework is used by the companies, they have higher values of earnings management, but on the other hand, the value relevance of the accounting elements suffered an improved. The negative influence is also found by Lin et al (2012) who considers that, for German companies, a regress on the mitigation of earnings management is a more common impact. Similar results were found by Callao and Jarne (2010) who analyzed the value of earnings management and who concluded that after the adoption of the international accounting measures, an increase in their value is expected. Moreover, the voluntary adoption of the IFRS for individual financial statements do not reveal other conclusions. According to Van Tandeloo and Vanstraelen (2005) the volunatry adopters of the international accounting standards do not have lower

values of earnings management in comparison with the entities that have not adopted them (they still use the national accounting framework). The explanations are related with the flexibility that arises in the implementation of the new regulation (Capkun et. al., 2013) and on the other hand, the negative impact could be due to the fact that several entities keep on using the national accounting regulation and not the international one.

Regarding the research conducted on Romania, Brad et. al (2014) concludes that there is a mitigation of the earnings management as there is an increase in the net profit volatility, an increase in the ratio between net profit volatility and cash flow from operations volatility and a smaller negative correlation coefficient between accruals and cash flow from operations.

Considering these features, the present research tries to reveal the impact of IFRS adoption on the earnings management using a similar methodology with the one developed by Brad et al. (2014). The methodology differs from the previous one as there are other entities that are used in the analysis and other variables of influence. The present research, provides evidence about the robustness of the results by reestimating them with the bootstrap procedure with replacement procedure.

3. Methodology of research

In order to reveal if there is any difference on the value of earnings management computed using the Romanian Accounting Standards and the international ones (IFRS), an analysis was conducted on the entities that are listed into Bucharest Stock Exchange. According to Financial Supervisory Authority, 71 companies have to report their individual financial statements using the IFRS accounting regulation. From them, one company has bonds as the object of trading and one was delisted in 2012 (AZO). We have also excluded the companies that have a negative value of their own capital in 2010, 2011 or 2012. Moreover, the companies that have to report their individual financial statements under IFRS starting from 2013 were also excluded. From the analysis, the companies that had opened their insolvency procedure were also excluded. Considering this, the research is conducted on a sample that contains 54 companies. For each of these entities, the financial information was collected for a three year period of time. As a fact, for 2010 and 2011 the financial information was collected using the RAS framework,

while for 2011 and 2012 the financial information was collected using the IFRS framework.

Regarding the measures of financial information, we collected information related with the value of net profit, the size of the company (measured through the logarithmic value of total assets), the changes in the value of net sales, the changes in the value of debt (both the debt on long term and the debt on short term), the number of stocks that each entity has, the type of the auditor that each company has (the main literature provides evidence that companies that have an auditor from Big 4 report more transparent information in their financial statements) and the effective rate of taxation that each entity has.

In order to provide evidence if there is any significant difference between the values of earnings management from 2010-2011 and the values of earnings management from 2011-2012, we looked at the three main methods of estimation. The first one is focusing on the value of net profit scaled by total assets. The idea is found in other research studies according to which a higher volatility of net profit is related with a lower value of earnings management. Its variability is found by conducting a regression using the value of net profit as dependent variable on several specific individual factors. In order to test the difference, the variability of residuals of the net profit is compared between the two periods of time (each residual series takes into account the accounting measures). The regression on which the residuals are estimated is found in equation (1).

$$\begin{aligned} \Delta NP_i = & \alpha_0 + \alpha_1 \times Size_i + \alpha_2 \times Growth_i + \alpha_3 \times \Delta Eissue_i + \alpha_4 \times Debt_i + \\ & + \alpha_5 \times Dissue_i + \alpha_6 \times Turnover_i + \alpha_7 \times Auditor_i + \\ & + \alpha_8 \times Effecive\ tax\ rate_i + \alpha_9 \times CF_i + \varepsilon_i \end{aligned} \quad (1)$$

Where:

ΔPN is the variability of net profit scaled by total assets.

$Size$ is the size of the company, measured through the logarithmic value of total assets.

$Growth$ is the variability of net sales.

$\Delta Eissue$ is the changes in the number of stocks that the entities has.

Debt is the degree of indebtedness that the company has. It is computed as the ratio between the value of total debts and the value of own capital.

Dissue is the change in the value of debts.

Turnover is the turnover of the company computed as the ratio between net sales and the value of total assets.

Auditor is the type of the financial auditor that the entity has. The variable is a dummy variable. It takes 1 if the financial auditor is from BIG 4.

Effective tax rate is the effective tax rate that the company has.

CF is the value of cash flow from operations.

i is the index for each entity from our sample.

ε is the error term (the residuals on which the variability of indicators is tested).

The second measure that is used for quantifying the earnings management is based on the ratio between net profit fluctuations and cash flow from operations fluctuations as the variability of net profit can be influenced by the variability of cash flow from operations. In order to establish this ratio, the variability of cash flow from operations was tested on individual factors. The method of estimation is as before (in the case of net profit variability). The variability of residuals is found by testing the influence of individual factors on the difference encountered in the value of cash flow from operations, which is considered the dependent variable. This aspect is presented in equation (2):

$$\begin{aligned} \Delta CF_i = & \alpha_0 + \alpha_1 \times Size_i + \alpha_2 \times Growth_i + \alpha_3 \times \Delta Eissue_i + \alpha_4 \times Debt_i + \\ & + \alpha_5 \times Dissue_i + \alpha_6 \times Turnover_i + \alpha_7 \times Auditor_i + \\ & + \alpha_8 \times Effective\ tax\ rate_i + \alpha_9 \times CF_i + \varepsilon_i \end{aligned} \quad (2)$$

Where ΔCF is the variance of cash flow from operations scaled by total assets.

Considering the results found from equation (1) and (2), the ratio between the variability of net profit and the variability of cash flow is computed and is statistically analyzed.

The last measure that is used to quantify the earnings management is based on Spearman correlation coefficient computed between the residuals of cash flow from operations and the residuals

of accruals. The value of accruals is calculated as a difference between the value of net profit and the value of cash flow from operations. There are studies that use the value of net profit before extraordinary items (Lin et. al, 2012). Considering that the Romanian entities do not report any extraordinary items, we used the value of net profit. Each of these variables (the value of cash flow from operations and the value of accruals) is analyzed on individual factors.

In order to compare the correlation coefficients we use the test developed by Fisher (1921). The test is based on initial transformation of the correlation coefficients (into r variables), on computing the z variable by using the new values and the dimension of each sample and on computing the probability associated with the z variable.

The formulas on which the estimation is conducted (which is the third measure of establishing the earnings management) are presented in equation (3) and (4).

$$\begin{aligned} CF_i = & \alpha_0 + \alpha_1 \times Size_i + \alpha_2 \times Growth_i + \alpha_3 \times \Delta Eissue_i + \alpha_4 \times Debt_i + \\ & + \alpha_5 \times Dissue_i + \alpha_6 \times Turnover_i + \alpha_7 \times Auditor_i + \\ & + \alpha_8 \times Effective\ tax\ rate_i + \varepsilon_i \end{aligned} \quad (3)$$

$$\begin{aligned} ACC_i = & \alpha_0 + \alpha_1 \times Size_i + \alpha_2 \times Growth_i + \alpha_3 \times \Delta Eissue_i + \alpha_4 \times Debt_i + \\ & + \alpha_5 \times Dissue_i + \alpha_6 \times Turnover_i + \\ & + \alpha_7 \times Auditor_i + \alpha_8 \times Effective\ tax\ rate_i + \varepsilon_i \end{aligned} \quad (4)$$

Where ACC is the value of accruals that the company has and CF is the value of cash flow from operations.

4. Additional analysis

In order to shed the robustness of the results, all three indicators were also computed using the bootstrapping technique with replacement. The method is based on using non-parametric techniques of estimation as the distribution of residuals is not a-priori known. Using this technique, we can obtain more information about the initial variables. The way it is implemented is based on several steps: selecting a similar number of observations with the one found on initial sample, estimating the regression in order to determine the residuals and computing the variance of the residuals or the

coefficient correlation. The process is repeated 500 times. For each indicator, the mean is afterwards computed and its statistically significant difference is analyzed.

5. Results and discussions

The purpose of this research is to provide evidence of any significant difference between the value of earnings management computing by using national and international accounting framework. We considered that a descriptive statistic of the elements can provide additional information related to the variables that are included into the analysis. We choose to provide a comparison between the values in mean, median and in standard deviation that were registered before and after the adoption of the international regulation.

The results about the differences encountered in mean for the independent and dependent variables are presented in Table 1.

The results correlated with the differences in median are revealed in Table 2.

The results that look at the standard deviation are presented in Table 3. In order to observe if there is any difference in the value of the standard deviation measured before and after the adoption of the International Financial Reporting Standards we use the Levene test. Its advantage is that its value is not affected by the fact that the variables do not have a normal distribution.

Table 1

**Descriptive statistic of the variables included into the analysis-
mean analysis**

Indicator	Mean		
	RAS	IFRS	p-value
Dependent variables			
<i>ΔPN</i>	-0.0062	0.0032	0.3840
<i>ΔCF</i>	0.0085	0.0051	0.8333
<i>ACC</i>	0.0499	0.0411	0.7428
<i>CF</i>	-0.0291	-0.024	0.4970
Independent variables			
<i>Size</i>	8.2502	8.2623	0.9167
<i>Growth</i>	0.0568	0.0326	0.6553
<i>Eissue</i>	0.1183	0.7382	0.4051
<i>Debt</i>	0.7453	0.9758	0.3536

Indicator	Mean		
	RAS	IFRS	p-value
<i>Turnover</i>	0.7938	0.6995	0.5880
<i>Dissue</i>	0.2882	0.6995	0.6218
<i>Auditor</i>	0.2777	0.3333	0.5353
<i>Effective tax rate</i>	0.2149	0.1302	0.0166**

Where ** denotes level of statistical significance at 5%.

It can be observe that there is a significant difference between the value of effective tax rate measured before and after the implementation of the IFRS.

In Table 2 are presented the differences found in the value of median measured before and after the adoption of the IFRS. It can be observed that there are statistically significant differences in the value of effective tax value and of the growth independent variable, the first one being significant at 10% and the second one at 5%.

Table 2

**Descriptive statistic of the variables included into the analysis-
median analysis**

Indicator	Median		
	RAS	IFRS	Wilcoxon prob.
Dependent variables			
ΔPN	0.0002	9.41*E-05	0.8417
ΔCF	0.0087	0.0072	0.8082
<i>ACC</i>	0.0448	0.0352	0.7517
<i>CF</i>	-0.033	-0.0233	0.5129
Independent variables			
<i>Size</i>	8.2135	8.1983	0.8658
<i>Growth</i>	0.0898	0.0194	0.0965*
<i>Eissue</i>	0.0000	0.0000	0.2468
<i>Debt</i>	0.3608	0.4267	0.5951
<i>Turnover</i>	0.6145	0.5571	0.6252
<i>Dissue</i>	0.0495	0.0299	0.5532
<i>Auditor</i>	0.0000	0.0000	0.6209
<i>Effective tax rate</i>	0.1724	0.1414	0.0221**

Where **, * denotes level of statistical significance at 5% and 10%

In Table 3, there are significant differences in the value of accruals that the entity had before and after the adoption of the IFRS.

Regarding the independent variable it can be seen that we have statistically significant differences on the variable that looks at the difference of how many stocks a company has. Other significant differences can also be found on the effective tax rate that the company uses. In fact, for the effective tax rate, we have significant differences in mean, median and variance.

Table 3
Descriptive statistic of the variables included into the analysis

Indicator	Mean		p-value
	RAS	IFRS	
Dependent variables			
ΔPN	0.0477	0.0635	0.2177
ΔCF	0.0833	0.0827	0.8723
<i>ACC</i>	0.0664	0.0528	0.037**
<i>CF</i>	0.052	0.0861	0.9529
Independent variables			
<i>Size</i>	0.5936	0.5983	0.9694
<i>Growth</i>	0.2488	0.3097	0.9896
<i>Eissue</i>	0.4065	5.4340	0.0894*
<i>Debt</i>	0.9343	1.5595	0.1563
<i>Turnover</i>	1.0511	0.7215	0.4879
<i>Dissue</i>	1.1560	0.8797	0.6149
<i>Auditor</i>	0.4521	0.4758	0.2176
<i>Effective tax rate</i>	0.2179	0.1340	0.0195**

Where ** denotes level of statistical significance at 5%.

As it can be observed from Table 1, Table 2 and Table 3, we have few differences between the values of dependent and independent variables, considering both the national and the international accounting framework. As a fact, considering these results we are unable to provide a conclusion about the changes that occurred in the value of earnings management.

In Table 4 are presented the results of the analysis conducted for each variable that was considered as a dependent one, such as the variability of net profit, the variability of cash flow from operations and the correlation between accruals and the values of cash flow from operations.

Table 4
**Earnings management measured by using the RAS and
 by using the IFRS**

Earnings management	RAS	IFRS	p-value
ΔPN *	0.032793	0.052137	0.0882*
ΔCF *	0.066918	0.060499	0.5510
ΔPN * / ΔCF * (computed as the ratio between variances)	0.49004	0.86178	0.0882*
Spearman Correlation of CF * and ACC *	0.016657	-0.57573***	0.000681***

Where ***, * denotes statistically significant at 1% and 10%.

The sign * associated with dependent variable refers to the variance of the residuals or to the correlation of the residuals.

From Table 2 it can be observed that there are statistically significant differences between the value of earnings management measured by using RAS and the value of earnings management measured by using IFRS. On one hand, a fluctuation on net profit can be found. Regarding the second measure it can be concluded that the variability of net profit is not influenced by the variability of cash flow from operations. As a fact, when we estimate the ratio between the variability of net profit and the variability of cash flow from operations we find that higher variability of this indicator is encountered which could suggest a higher degree of accounting transparency. Regarding the correlation between the cash flow from operations and the value of accruals, it can be concluded that there is no improvement in the value of earnings management, but rather an increase of it. A more negative coefficient suggests an increase in earnings management (accruals are used to create them). The results are contrary to the results found by Brad et al (2014) where an improvement in the correlation coefficient is also detected. As the switch costs from national to international accounting framework are relative high, there is a high probability that the correlation could become significant less negative or more positive in time.

In order to shed the robustness of the results, we conducted additional analysis. This is based on testing the variability and the correlation of the residuals from equations (1), (2), (3) and (4) using the bootstrapping procedure with replacement. The analysis is conducted in Matlab. The results are found in Table 5.

Tabel 5
Robustness of the results by using the bootstrapping procedure

Earnings management	RAS	IFRS	p-value
ΔPN *	0.033584	0.084473	<0.0001***
ΔCF *	0.065922	0.058970	<0.0001***
ΔPN * / ΔCF * (computed as the ratio between variances)	0.50945	1.43247	<0.0001***
Spearman Correlation of CF * and ACC *	-0.72092	-0.73739	0.000044***

Where ***,* denotes statistically significant at 1% and 10%.

The sign * associated with dependent variable refers to the variance of the residuals or to the correlation of the residuals.

From Table 5, it can be seen that there is a fluctuation in all three metrics of earnings management. The results indicate that significant difference can be seen in the mean of net profit fluctuations. For comparison, the mean indicator was used instead of variance as the bootstrapping procedure provides the variance of residuals for estimation that is repeated. The same measure is used for establishing the ratio between fluctuations of net profit and fluctuations of cash flow from operations, even though the fluctuation of cash flow from operations seems to decrease. For both indicators an improvement in the value of earnings management can be observed. For the third metric, the correlation coefficients are statistically significant as we have 27000 observations. A more negative value is sign of an increase of earnings management, thus of more private benefits. The results are partially in accordance with the results found by Lin et al (2012) except that the authors provide evidence of the negative impact on net profit fluctuations and also on the ratio between the net profit fluctuation and cash flow from operations fluctuations.

In conclusion, it could be observed that the results on Romanian market are mixed. While an improve in the variability of net profit is observed (higher values) and an uncertain results is obtained to the variability of cash flow from operations (uncertain change is observed when the initial sample of 54 companies is used and it is observed a statistically significant decrease when the bootstrapping procedure is applied), a more negative relationship exist between the value of accruals and the value of cash flow from operations, which is a sign of an increase in the value of earnings management.

6. Conclusions

The idea of research this study is to reveal if any significant difference were observed between the value of earnings management measured using the RAS framework and the earnings management measured using the IFRS framework and if managers get more private benefits after the adoption of the international regulation. The analysis was conducted on a sample of 54 companies that are listed into the Bucharest Stock Exchange considering that they have to report their individual financial statements using the IFRS accounting measures from 2012.

In order to be in line with the purpose of research, a comparison between the variability of the residuals of net profit, the variability of the residuals of cash flow from operations and the change of the correlation between the residuals of cash flow from operations and the residuals of accruals was tested. The results proved that there are higher values for the residuals of net profit (there is a higher fluctuation of the net profit), while, for the correlation between residuals of cash flow from operations and residuals for accruals lower values are detected (sign of an increase of the earnings management and of more private benefits). For the residuals of the difference of cash flow from operations the results are not statistically significant. Thus, the variability of the ratio between variability of net profit and the variability of cash flow from operations is due to the variability of the net profit.

In order to shed the robustness of the results, the analysis was repeated using the bootstrapping with replacement procedure. The results are partially similar with the results found on individual analysis, except that a decrease in the fluctuation of the differences between cash flow from operations is observed. The correlation coefficient is more negative suggesting an increase in the value of earnings management. The results are partially in accordance with the results found by Lin et al. (2012)

It can be concluded that for some elements (such as the variability of net profit) an improvement in the value of net profit was detected once the companies have to use the international regulation and not the national accounting framework. The results should also take into account that during the transition period from the national accounting regulation to the international accounting measures there are higher cost. The effect of an improvement in the degree of

transparency of the financial information can be detected after a longer period of time.

Regarding the problems of this research, we consider that manual collection of the data could create biased into the results. Moreover, due to the fact the analysis is conducted only on 54 companies there could also encountered biased problems. Further research looks at repeating the analysis considering the two accounting approaches by analyzing the value relevance and by studying the changes that occurred in the value of discretionary accruals that an entity can have.

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