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Earnings Quality of Swiss Companies after a turn away from IFRS back to Swiss GAAP

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Abstract

The study focused on the examination of earnings management under IFRS and Swiss GAAP. The major focus is to investigate the implication of the switch from IFRS to Swiss GAAP on earnings management for Swiss companies. The quantitative research design was employed. Secondary data of 117 non-financial firms operating on the Swiss Stock Exchange (SIX) was used for a period of nine financial years (2010-2018). The data were analyzed using descriptive statistics, independent sample t-test, and pooled OLS regression technique. The findings suggest a general trend of discretion applied in both standards but highlight those differences in the magnitude of accruals and income smoothing are not significant between the two standards. Whereas Swiss GAAP appears to be more associated with income smoothing, the companies that move from IFRS turn to more conservative accounting choices through the magnitude of accruals than smoothing reported earnings, and this is most common around the period of change. The study also supports theories of the debt-equity hypothesis (Watts & Zimmerman, 1990) and the matching concept (Dechow et al., 1995), but does not obtain results that support the political cost hypothesis.

Keywords: earnings management, earnings quality, accounting standard, earnings smoothing, discretionary accruals, IFRS, Swiss GAAP, accounting regulation

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Introduction

Earnings quality is measured by the extent to which a firm's reported earnings accurately reflect income for a period. A firm's reported earnings are as much a function of its accounting methods as they are a measure of its business success, at least over the short run (Scott, 2003). Hence, reporting standards are generally considered a determinant of earnings quality.

Since 2005 all listed companies in the European Union have been required to align their financial reports with the IFRS. Next to improved quality of financial statements the regulators' motives for the reform were to enhance the comparability of financial statements as well as to increase corporate transparency (Doukakis, 2014). Although not being part of the European Union, Switzerland also participated in this considerable change in financial reporting regulation. Since then, multinational companies had to use IFRS for their consolidated financial statements.

Non-multinational companies listed on the Swiss stock exchange could either continue using the Swiss GAAP or comply with the international accounting standards (Horton, Serafeim, and Serafeim, 2013). While Swiss GAAP shares the same major reporting objective of a 'true and fair view' with IFRS, the degree of complexity and number of accounting rules substantially differ across the two standards. In our sample between 2008 and 2013, 34 out of 141 (24%) listed Swiss firms that are eligible for switching made use of this particular option (hereafter, 'switching firms').

As some companies in Switzerland adopt the local Swiss GAAP in favor of the IFRS, a re-measurement of their financial statements reflects such changes. A survey conducted by Deloitte indicates that six companies registered on the Swiss stock exchange switched from IFRS to Swiss GAAP during the year 2013.

This move saw an average decrease in the length of the financial statements of these companies by 33%, which was mainly since Swiss F required less information and disclosure notes. It also led to an average decrease in the equity of these companies, whereby, three of the companies reported a decrease of less than 10% while the others reported a decrease of between 50-61% (Bryois, Ganiere, & Welser, 2014). These changes highlight some major differences that may exist between the two reporting standards.

The study may serve as a contribution to European policymakers and standard setters to assess whether the change in European accounting regulation has reached its stated goals. Moreover, the paper should provide valuable information for investors to better comprehend the impacts of mandatory IFRS adoption. By focusing on only Swiss companies the impacts of managerial incentives towards earnings management are mitigated. Factors such as the legal and political environment as well as macroeconomic, cultural, and institutional arrangements are assumed to be constant in 2004 and 2005. Thus, potential differences in earnings quality between the pre- and postadoption period are made attributable to the change of accounting standards.

The remainder of this paper is structured as follows. First, a literature review will give definitions for earnings quality and earnings management as well as incentives for earnings management. After that, an overview of the possible implications of IFRS adoption on earnings quality will be provided. The literature review will be complemented by emphasizing the differences of the Swiss accounting regulation before and after the reform in 2005. The following part will specify the methodology including the author's hypotheses. After a short description of the sample data, the results of the study will be presented. Finally, the findings of the paper will be summarized in the conclusion. Furthermore, practical implications, limitations of the study, and suggestions for further research will be provided.

Theoretical Background

Earnings Management

Earnings indicators are important accounting numbers that reflect the performance of management and an economic entity in general (Dechow, 1994). Therefore, it is not uncommon for management to take action to ensure that earnings are attractive and provide good signals. One avenue that is often explored in ensuring attractive earnings is earnings management.

While there is no consensus on what earnings management entails, some definitions have been put forward by scholars which over time have formed the foundation for earnings management discussions. Popular among these definitions is the one by Healy and Wahlen (1999) who define earnings management as any action initiated by management via the application of judgment in structuring and reporting financial transactions to misled users on the fundamental economic performance of an entity or induce contractual outcomes based on accounting numbers. Similarly, Callao et al. (2014) noted that earnings management is usually an intentional act in corporate reporting aimed at achieving specific goals by varying accounting practices which may not necessarily violate accounting principles but exploit the flexibility of choice associated with these principles. Consistent with the aforementioned definitions, Graham et al. (2005, p.6) found that "managers are interested in meeting or beating earnings benchmarks primarily to influence stock prices and their own welfare via career concerns and external reputation, and less so in response to incentives related to debt covenants, credit ratings, political visibility, and employee bonuses".

This explanation upholds the conclusion in Healy and Wahlen (1999) that the management can apply earnings management as a manipulating tool to either mislead users on economic performance or to influence contractual outcomes of companies.

The discourse on earnings management is not recent as related subject matters have been interrogated in literature as far back as the middle of the nineteenth century (Ruiz, 2016). Although Healy and Wahlen (1999) is not the first study on earnings management, the definition provided by these authors has gained wide popularity in understanding the complex nature of earnings management. According to them, earnings management results from the application of judgment by managers in “financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers” (p. 368).

They further itemized some conditions and effects of earnings management ranging from the exercise of judgment and discretions to gaining undue advantage from the actions of misled financial statement users. These undue advantages based on literature include the desire for high earnings-based compensation packages and bonuses, tax reduction, higher share price during public offers, meeting analysts forecast, meeting loan covenants and terms (Dechow & Skinner, 2000; Malofeeva, 2018).

Benish (2001) added that earnings management is opportunistic in nature as it involves exploiting accounting principles, methods, and operations in preparing and presenting financial statements that show a less truthful representation of the economic reality of a firm. However, departing from the view of most researches, Jiraporn et al. (2008) submitted that although most researchers advance that earnings management is usually for private gains, this is not always the case as they found that earnings management can be beneficial for firms that have high agency cost resulting in better firm value.

In an earlier study, Schipper (1989) viewed earnings management as an intentional act aimed at gaining private benefits such as loss reduction and improved earnings by meddling with the external financial reporting process. According to Schipper, earnings management relates to manipulations done during reporting to external stakeholders only. That is, earnings management is not an in-house reporting issue. Broadly speaking, Yuliana et al. (2015) noted that actions by managers desiring to improve or maintain earnings in order to signal a performance different from the underlying economic reality are all issues bothering on earnings management. In addition, Callao and Jarne (2010) argued that earnings management is not illegal per se as it involves the application of “accounting practices within limits available within a comprehensive basis of accounting by management in order to achieve a desired result” (p. 160). In other words, earnings management is made possible because of loopholes within the accounting framework applied. This is equally the position of Davidson et al. (1987) as cited in Toumeh and Yahya (2019) who posited that earnings management is “the process of taking deliberate steps within the constraints of generally accepted accounting principles to bring about a desired level of published earnings” (p. 17).

Specifically, Dechow and Skinner (2000) asserted that earnings management should not be misconstrued for fraud since both share similar features. They further argued that determining the intention of management is paramount in differentiating between earnings management and fraud. However, since management's intention is mostly unobservable, they submitted that manipulations done within the ambit of generally accepted accounting principles should be seen as earnings management while those outside of it are simply fraudulent. Figure 1 summarises the position of Dechow and Skinner (2000) which is similar to the position taken by Callao et al. (2014) who defined earnings management as a “purposeful intervention in financial reporting, designed to reach earnings targets by varying accounting practices.

However, it is an action which takes place without necessarily violating accounting regulations, and which takes advantage of the possibilities of choice in accounting policy” (p. 137).

From the definitions, it is observed that earnings management depend a great deal on the application of judgment, and Toumeh and Yahya (2019) tow this line of reasoning when they posited that for managers to engage in earnings management, some level of judgment has to be exercised and this usually stems from the flexibility of choice associated with the accounting standard in use.

Healy and Wahlen (1999) also added that in preparing the financial report, managers employ a range of discretions ranging from the judgment in making estimates, choosing from diverse permissive accounting methods to the timing of discretionary expenditures and corporate transaction structuring. Thus, the more judgments and discretions accounting principles and standards allow, the more the likelihood for earnings management.

Major differences between IFRS and Swiss GAAP

Like IFRS, Swiss GAAP is based on the 'true and fair view' principle. While IFRS concretizes the 'true and fair view' principle with detailed rules, Swiss GAAP relies rather on general concepts without specifying implementation or exceptions for special cases. The main difference between the two accounting standards is therefore not in their objectives or even in the rules they contain on the treatment of certain issues. Rather, it has to do with the level of detail in which the principles of the respective standard are set out.

The Swiss GAAP approach of avoiding detailed rules and leaving the concrete details to those who apply them in practice leads to a situation where the rules are no help, except in terms of the true and fair view principle, when it comes to assessing complex transactions. The result is that users have to define accounting principles themselves. The Swiss GAAP thus provides a certain degree of methodological freedom that users are glad to take advantage of. This means that differences in the way comparable transactions are treated can hardly be avoided. This can be a problem if being able to compare different entities is a major concern. Part of the definition of "true and fair view" in the Swiss GAAP framework is the requirement that information is geared to the needs of the recipients. To get a sure picture of an entity's financial position, financial performance and cash flows, the reader of the financial statements has to understand under what premises the reported figures came about. Since the Swiss GAAP gives users more room for maneuver than the IFRS, it is reasonable to assume that there would be a greater need in Swiss GAAP statements to explain the accounting rules applied and the calls of judgment made. In practice, however, specific explanations of this sort are usually not provided, or if so, are very limited. This can make it difficult for even informed readers to get a reliable view of matters.

Prior Research and Hypothesis Development

IFRS and Earnings Management

Proponents of IFRS have broadly argued that the adoption and implementation of IFRS by companies is beneficial and has led to better reporting quality and investors' protection (Fields et al., 2001), reduced information asymmetry through more disclosures and lower cost of capital (Landsman et al., 2012; Li, 2010), more liquidity associated with strong enforcement (Daske et al., 2013), higher value relevance of accounting numbers and lower earnings manipulations due to the limits imposed on managerial discretions by the rigorous and elaborate disclosures (Barth et al., 2008; Corsi & Mancini, 2010; Guenther et al., 2009). Conversely, opponents argue from a firm-specific dimension that the adoption and application of IFRS have led to higher net reporting costs, especially for small companies and those with higher insider ownership (Christensen et al., 2015; Hail et al., 2010), increased earnings management in a bid to manage earnings volatility (Callao & Jarne, 2010; Heemskerk & Van der Tas, 2006; Tendeloo & Vanstraelen, 2005), and higher audit cost (Raffournier & Schatt, 2018).

Restricting this discourse to earnings management, there are three streams of debate. One is that the application of IFRS reduces earnings management because the standards are rigorous as such, limits managerial discretion and flexibility in using estimates (Corsi & Mancini, 2010), and ensures more disclosure and financial openness (Houqu et al., 2016). The second is the converse position that earnings management increases in IFRS regimes when compared with non-IFRS regimes (Jeanjean & Stolowy, 2008) due to weakness in enforcement (Ahmed et al., 2013), unclear criteria, and subjective estimates (Capkun et al., 2016). Lastly, the third view is the midpoint, that there is no significant difference in the level of earnings management in either period (Liu & Sun, 2015).

It is worthy to note that earnings management is the application of judgment by managers in “financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers” (Healy & Wahlen, 1999, p.368).

According to Ball (2006), the adoption and implementation of IFRS have gained prominence globally such that a great number of countries are reporting via these standards, and Switzerland is not left out. Since the introduction of IFRS in Switzerland, a good number of the companies permitted to use IFRS, US GAAP, or Swiss GAAP chose to use IFRS possibly in a bid to harness the benefits associated with reporting via IFRS. This position is substantiated based on the 56% of companies listed on the Swiss Exchange as of August 2019 that use the IFRS reporting framework (IASB, 2019). However, the 2014 report by Deloitte revealed that between 2012 and 2013, fourteen (14) non-financial companies that earlier used the IFRS have switched to Swiss GAAP. Furthermore, as of 2016, the total number of non-financial companies that discontinued the use of IFRS for Swiss GAAP stood at forty-two (Stuve, 2015).

This trend has raised lots of questions, chiefly among which is why there is an increasing trend for companies to switch to the Swiss GAAP? What are the probable impacts that this trend will cause on the financial statement quality? In answering the former, Fiechter et al. (2017) documented based on the findings from a survey conducted that the main reasons for the switch revolve around the complexity of IFRS, the high administrative cost associated with IFRS, as well as the comparability of disclosures quality and transparency of Swiss GAAP with IFRS.

In addressing the latter question, which is the focus and motivation for this research, emphasis shall be placed on investigating the impact of switching from IFRS to Swiss GAAP on the level of earnings management in Switzerland. Although prior studies (Ahmed et al., 2013; Barth et al., 2008; Christensen et al., 2015; Corsi & Mancini, 2010; Houqu et al., 2016; Jeanjean & Stolowy, 2008; Liu & Sun, 2015; Stuve, 2015) exist on the effect of IFRS adoption on earnings management in many countries, including Switzerland, there is a paucity of an empirical investigation on the reverse as seen in Switzerland.

Barth et al. (2008) in their survey on voluntary adoption of IFRS within the period 1994 to 2003 found that lower (higher) levels of income manipulations were associated with countries that have (not) adopted IFRS. They opined that the reduction in alternative treatments by IFRS accounted for the reduction in management discretion which, in turn, minimized the capacity for earnings management. Therefore, they align with the transparency argument that IFRS allows for less discretion in reporting, which in turn minimizes earnings management.

However, Jeanjean and Stolowy (2008) are skeptical about this position as they argued from a regulatory institution perspective that the application of any accounting standards (IFRS inclusive) involves a substantial amount of judgment and discretion and the extent of discretion applied largely also depends on the specific attributes of the companies and the regulatory environment the companies operate in. Thus, they examined the effect of IFRS adoption in France, Australia, and UK on earnings management. Despite being members of the EU, France and UK have differences in their law orientations as France is a code law country while the UK is a common law country, thus making it possible to also investigate the role that regulatory orientation might play. The findings showed amongst others that earnings management increased in post-IFRS France, while it was relatively the same in post-IFRS UK and Australia. The conclusion from the study raises concerns on the effectiveness of IFRS to mitigate earnings management in countries having code law orientations (weak enforcement and regulatory incentive).

In agreement with the position of Jeanjean and Stolowy (2008) that reporting, operational, and regulatory institution characteristics have a huge impact on the IFRS-earnings management relationship, Ball et al. (2003) analyzed the earnings management behavior of firms operating in four Asian countries and discovered that managerial reporting incentives had a greater level of influence on the quality of financial reporting than the adoption of a high-quality standard. Similarly, Christensen et al. (2015) investigated if the quality of accounting standards or managerial incentives drive the level of earnings quality using a single country setting (Germany). Earnings quality was captured using different proxies (earnings management, value relevance, and timely loss recognition).

The analyses conducted revealed that although earnings management decreased for firms that adopted IFRS, this decrease was only observed for voluntary adopters and not mandatory adopters. They explained further that the reporting incentive associated with voluntary adopters accounted for the findings as it was likely that the flexibility introduced by IFRS was insufficient in reducing the level of earnings management in firms that had no reporting incentive to adopt IFRS in the first place.

To address the issue of whether high-quality accounting standards can mitigate earnings management in a code law country, Zeghal et al. (2011) investigated the adoption of IFRS by France. Extant studies support the inadequacy of IFRS in overriding reporting incentives of managers in code law countries. However, the findings of Zeghal et al. (2011) stood at variance with this position as they found using a sample of 353 listed companies for the period 2003 to 2006 that the introduction of IFRS is associated with high accounting quality and low earnings management. The results held true for companies with sound corporate governance mechanisms and those that required funding from external capital markets. The findings from the study buttress the importance of enforcement mechanisms in enhancing the effect of high-quality accounting standards on financial reporting quality.

Investigating within the German setting, Muhamad et al. (2019) contradict the findings of Christensen et al. (2015). Muhamad et al. found that German companies reporting using IFRS had a significant difference in the level of earnings management in comparison to those reporting using the German GAAP. In their study, they evaluated the difference in earnings management of 425 firm-year observations between the period 2003 and 2014 using descriptive analysis and align with the transparency argument that IFRS allows for less discretion in reporting, and this gives rise to lower earnings manipulations. This finding aligns with the finding of Khoo and Ahmad-Zaluki (2015) who observed using a sample of 231 companies and estimating earnings management based on the Kothari model that the convergence to IFRS by Malaysian companies resulted in a reduction in earnings management. Thus, justifying the transparency argument that IFRS curtails the discretionary tendencies of managers.

Using a sample of Canadian firms, Said (2019) examined the influence of IFRS on the practice of earnings management. The study measured earnings management using discretionary accruals as determined from the modified Jones model and found no statistical influence of IFRS adoption on earnings management. In other words, the practice of earnings management did not change despite the introduction of IFRS. This lends credence to the argument that the quality of financial reporting extends beyond just the use of high-quality accounting standards. In contrast, Sutrisno and Djashan (2017) found within the Indonesian setting that IFRS convergence improved reporting quality and mitigated accrual-based earnings management. Their analysis was based on a sample of 45 companies for 8 years (2008 to 2015) and agrees with the transparency arguments of using high-quality accounting standards.

In similar research by Rahmaningtyas and Mita (2017) on the effect of the adoption of IFRS on earnings management of companies operating in selected Asian countries¹, they found that the level of earnings management after the adoption of IFRS increased contrary to the argument that high-quality accounting standard ought to lead to higher reporting quality. They opined that the principle-based nature of IFRS actually provides management with more areas of judgment and in the absence of strong investors' protection; opportunistic managers tend to engage in earnings manipulations. This is also the position of Soderstrom and Sun (2007) who asserted that accounting quality depends on the tripartite influence and interactions among quality of enforcement, quality of accounting standard, and reporting incentives of individual firms. Consequently, deteriorations in any of these may likely account for a decline in accounting quality.

Focusing on a cross-country perspective, Rathke et al. (2016) investigated the effect of adopting IFRS on the level of earnings management of selected Latin American countries. Their study was a comparative analysis of companies operating in Latin American, Continental Europe, and Anglo-Saxon countries. The findings were in two folds. First, they found earnings management was highest in firms operating in Latin American countries. Second, US cross-listed companies in Latin America and Continental Europe generally had a high level of earnings management, but this level was lower in comparison to those listed only in the domestic exchanges. By implication, the findings revealed that aside from the presence of high-quality accounting standards and reporting incentives, country-specific attributes significantly affect the quality of accounting information and the level of earnings management.

Quite related to the study of Rathke et al. (2016), Lippens (2010) also conducted a cross-country survey on the compulsory adoption of IFRS by the EU and the effect on earnings management. The study examined both real and accrual-based earnings management and observed that both forms increased in the subsequent years of adopting the IFRS. It was also observed that though IFRS required more disclosures, managers substituted accruals-based earnings management for real earnings management when it was difficult to engage in the former. To ascertain if the findings were driven by country-specific attributes, the study tested for the effect of the variable 'country' and found no significant difference. Thus, a plausible explanation for the non-effect of IFRS on earnings management may be related to the reporting incentive and enforcement mechanisms rather than country-specific attributes.

Doukakis (2014) also investigated the association between mandatory adoption of IFRS and earnings management of European-based companies. The sample consisted of 15,206 firm-year observations for 11 years (2000 to 2010) and the findings aligned with most cross-country extant literature that the mandatory introduction of IFRS is not associated with reduced earnings management.

According to the author, country-specific attributes and reporting incentives rank higher than the quality of accounting standards in influencing financial reporting quality.

Swiss GAAP and Earnings Management

Using a sample of Swiss companies, Stuve (2015) investigated the effect on earnings quality resulting from a mandatory change in accounting standards (Swiss GAAP to IFRS). The study focused on 144 companies in 2004 (pre-adoption era) and 2005 (post-adoption era) and used the modified Jones model to determine the extent of earnings management. The findings revealed that earnings quality and management remained stable pre and post IFRS adoption. Thus, the adoption of IFRS had no significant impact on earnings management. In addition, companies that switched from Swiss GAAP to IFRS were more conservative than those using the Swiss GAAP. By implication, the study does not align with the comparability nor transparency arguments for using the high-quality standard as it failed to see any difference in the use of IFRS as regards the level of earnings management. In contrast, Patuto (2016) examined the effect of switching from IFRS to Swiss GAAP on one of the management's specific discretionary decisions (goodwill). The study found that "companies are tempted to eliminate Goodwill under Swiss GAAP because they can improve profitability" (p.49). Consequently, it may be deduced that companies that switch from IFRS to Swiss GAAP do this in order to manage earnings by utilizing discretion on the reporting of goodwill. Thus, a reporting incentive accounts for the difference associated with the use of IFRS and Swiss GAAP.

Fiechter et al. (2017) conducted an investigation on the 'determinants and consequences of a voluntary switch from IFRS to Swiss GAAP using a sample of 628 firm-year observations between 2008 and 2013. They found that switching companies were mainly small companies having a greater percentage of domestic ownership. Also, the huge administrative cost associated with IFRS reporting was the primary reason for the switches observed and fallout from the switches was a substantial decrease in the disclosure but with no negative capital market effect. By implication, we think that the finding of a decrease in disclosure is likely to be associated with earnings management, although this was outside the scope of the study by Fiechter et al. (2017).

Hypotheses Development

Swiss GAAP is becoming more attractive for Swiss companies because of the compact (around 200 pages) principles-based recommendations that the companies can use to achieve the same objective (true and fair view) as the detailed (over 3,000 pages) IFRS/IAS rules-based standard. The advantages of using this standard (e.g., simplification of benchmarking against competitors, facilitation of management, control, and decision-making, etc.) have seen about 40 Swiss listed companies switching from IFRS to Swiss GAAP since 2008. However, the rules diverge in some cases, for example, recognition of goodwill, pension liabilities, etc (Balkanyi&Wandeler, 2015).

Due to these differences and prior literature which suggests IFRS be of higher quality than other country-specific reporting standards (e.g., Ho et al., 2015), it is questioned whether the SIX exchange registered non-financial companies reporting under Swiss GAAP engage significantly more in accrual-based earnings management compared to their counterparts reporting under IFRS. This question leads to the following hypothesis:

Hypothesis 1: *SIX exchange-listed companies reporting under Swiss GAAP engage significantly more in accrual-based earnings management than their counterparts reporting under IFRS.*

As mentioned above, Swiss GAAP has fewer disclosure requirements than IFRS. This is causing more listed companies in Switzerland to switch from the more comprehensive IFRS to the less comprehensive local GAAP. During this transition, drastic changes in the financial statements of some companies are observed. This transition can lead to companies using the differences in accounting standards to perform earnings management, which directly reduces the quality of earnings reported under the local standard. Therefore, we hypothesize:

Hypothesis 2: *Following the adoption of Swiss GAAP, SIX exchange-listed companies engage significantly more in earnings management as compared to prior years when reporting under IFRS.*

The methods developed to test the hypotheses above will be discussed in the following chapter. The goal is to determine whether Swiss GAAP provides more opportunity for management discretion than IFRS and whether Swiss-listed companies take advantage of this opportunity when changing between the reporting standards. The level of earnings management will determine the impact of the standards on the quality of reported earnings.

Research Methodology

Sample Selection

The sample selected for this study involves all listed companies (SIX exchange) obtained from the ORBIS database for the period 2010 to 2018. In line with Leuz et al. (2003), financial companies were excluded from the sample (e.g., banks, insurance, and reinsurance companies). The search also excluded companies with no financial data for the specified periods, state-owned entities, and companies reporting under US GAAP. The annual reports published by the companies were consulted provided the company only lacked data for a single variable within a single year. If the data could not be found, the year was removed from the sample. This led to a total of 117 companies (14 of which are SMI listed companies). The main sectors represented are manufacturing, industrial repairs and construction, transportation, telecom, and service industries. The sample was divided into three sub-groups; those that remained under IFRS (IFRS), those that were reporting under Swiss GAAP for the entire sample period (LOCAL GAAP), and those that moved from IFRS to Swiss GAAP (SWITCHERS). An independent comparison was done for the SWITCHERS sub-sample between the PRE and POST adoption periods of 24 companies. Our final sample includes 936 firm-years (117 unique firms) spanning the nine-year period, 2010–2018. The table below shows the categorization:

Table 1: Sample Categorization.

IFRS	LOCAL GAAP	SWITCHERS
62 companies (496 firm-year observations)	31 companies (264 firm-year observations)	24 (176 firm-year observations. This was further split between IFRS and Swiss GAAP).

Model Specification

To test our hypotheses, we use both the incidence and magnitude of discretionary accruals as indicators of upward earnings management. To estimate discretionary accruals, we use the modified Jones (1991) model described in Dechow et al. (1995).

$$\frac{TAC_{it}}{A_{it-1}} = \alpha_1 \left(\frac{1}{A_{it-1}} \right) + \alpha_2 \left(\frac{\Delta REV_{it}}{A_{it-1}} - \frac{\Delta REC_{it}}{A_{it-1}} \right) + \alpha_3 \left(\frac{PPE_{it}}{A_{it-1}} \right) + \epsilon_{it}$$

Where:

TAC_{it} = Total accruals for firm i in year t

ΔREV_{it} = Change in revenue for firm i in year t

ΔREC_{it} = Change in receivables for firm i in year t

PPE_{it} = Gross property, plant, and equipment for firm i in year t

A_{it} = lagged total assets for firm i in year t

The equation is matched by the industry, and compared against the standard within the industry, such that discretionary accruals reflect the excess above the industry standard. Prior researchers (e.g., Leuz et al., 2003; Van Tendeloo & Vanstraelen, 2005) further considered the correlation between total reported accruals and operating cash flows as a proxy for earnings smoothing: whereby, a negative correlation between accruals and operating cash flow indicates the use of accruals to smooth the variability in operating cash flows. Everything being equal, differences in the correlation between accruals and operating cash flows indicate variations in the degree of earnings smoothing (Van Tendeloo & Vanstraelen, 2005).

The main independent variable is IFRS, which represents companies that report under IFRS within the sampled period (used as a dummy variable with IFRS set as 1, otherwise 0). Hence, we consider the effect of IFRS on the correlation between accruals and operating cash flows (IFRS * CF).

To control for differences in earnings management incentives, we include the following variables:

- 1) The natural logarithm of total assets (LNASSETS): To proxy for size, which is itself a proxy variable for political attention. According to the political cost hypothesis (Watts & Zimmerman, 1990, pp. 139-140), large firms are more likely to use accounting choices that reduce reported profits than small firms. This variable is expected to have a negative relationship with discretionary accruals.
- 2) A leverage or gearing variable (GEARING): Following the debt-equity hypothesis as indicated by Watts & Zimmerman (1990), highly leveraged firms are more likely to engage in upward earnings management to avoid debt covenant violations. a positive relationship is expected between these variables and discretionary accruals; Whereby, a positive sign is expected for the relationship when discretionary accruals are positive, and a negative sign is expected when discretionary accruals are negative.
- 3) The absolute value of Operating Cash Flow scaled by lagged total assets (CF): This variable controls for performance. Following the matching principle, Dechow et al. (1995, p 209) suggest that in the event year, the accrual changes in relation to operating cash flows should be opposite in sign. In this regard, the event-year accrual changes represent non-discretionary accruals that are made with the objective of eliminating temporary mismatching problems in cash flows from operations. Therefore, a well-specified model of non-discretionary accruals should control for this variable to ensure that matching is the reason for this negative correlation (see Van Tandeloo & Vanstraelen; pp. 165-167). Likewise, Burgstahler et al. (2006, p 991) report that firms can use accruals to hide bad current performance or to under-report good performance, such that a high negative correlation between accruals and operating cash flows indicate: ceteris paribus, smoothing of reported earnings that do not reflect a firm's current performance.
- 4) Return on Assets (ROA) expressed in percentage form: We include this variable as the second measure of performance. Given that operating cash flow tests for earnings smoothing as implied by Van Tandeloo & Vanstraelen (2005; pp 170-176), We include ROA in the regression model to test the validity of performance as a control for discretionary accruals as proposed by Rodrigues, Lima de Melo, & Paulo (2019). We consider that more profitable firms would be more likely to smooth reported earnings by under-reporting earnings during extremely good years in order to save for rainy days. Therefore, we expect ROA to have a positive relationship with discretionary accruals.

Hence, the following empirical models are further developed:

$$DAC_t = \beta_0 + \beta_1(IFRS_t) + \beta_2(CF_t) + \beta_3(LNASSETS_t) + \beta_4(GEARING_t) + \beta_5(ROA_t) + \beta_6(INDU) + \epsilon_{1t}$$

$$TAC_t = \beta_0 + \beta_1(IFRS_t) + \beta_2(CF_t) + \beta_3(IFRS_t * CF_t) + \beta_4(LNASSETS_t) + \beta_5(GEARING_t) + \beta_6(ROA_t) + \beta_7(INDU) + \epsilon_{2t}$$

Where the dependent variables are:

DAC_t = Absolute value of discretionary accruals in year t scaled by lagged total assets.

TAC_t = Absolute value of total accruals scaled by lagged total assets as calculated within the model.

Independent variables are:

IFRSt = Dummy variable where companies reporting under IFRS are denoted 1, otherwise 0.

CF_t = Operating Cash Flow as computed within the model. i.e., EBIT Minus Total Accruals (TAC_t), scaled by lagged total assets.

LNASSETSt = Natural logarithm of total assets in year t.

GEARING_t = Ratio of long-term debt to equity in year t (or the GEARING ratio as provided in the ORBIS database).

INDU = 2-digit NACE Rev. Code.

Results

This section presents the reports obtained from the discretionary accrual model developed by Dechow et al (1995) and includes economic and industry controls as further used by other researchers (e.g., Van Tandeloo&Vanstraelen, 2005; Rodrigues et al. 2019, etc.).

The following tables present the regression outputs and correlation coefficients for the magnitude of earnings management and earnings smoothing.

Table 2 below indicates higher mean and median values for negative discretionary accruals (i.e., mean = -0.0473, median = -0.0347) than for positive discretionary accruals (i.e., mean = 0.0452, median = 0.0301). This means that in general, firms manage more towards income-decreasing discretionary accruals.

Table 2: Descriptive Statistics of Absolute Discretionary Accruals, Total Accruals & Cash Flow.

PANEL A	N	Mean	Median	Min	Max	STD
/DAC/	716	1.59E17	0.00098	-0.35	0.359	0.068
DAC<0	350	-0.0473	-0.0347	-0.35	-0.00024	0.049
DAC≥0	366	0.0452	0.0301	0.000138	0.351	0.049
t. test	t = 25.1. (p = 0.000). (Two tailed test)					
TAC	716	-0.0355	-0.0344	-0.389	0.317	0.0679
TAC<0	552	-0.0596	-0.0492	-0.389	-0.00013	0.0502
TAC≥0	164	0.0456	0.0257	0.000184	0.317	0.0559
t. test	t = 21.64. (p = 0.000). (Two tailed test)					
CF	716	0.112	0.109	-0.297	0.419	0.091

PANEL B: Comparison of absolute discretionary accruals.

		Total Sample Mean		SWITCHERS Mean	
		IFRS	LOCAL GAAP	PRE	POST
	/DAC/	-0.000491	0.000956	0.01113	-0.00143
	DAC<0	-0.0460	-0.046	-0.049	-0.057
	DAC≥0	0.039	0.0499	0.056	0.051
p.value. (t.stat)	DAC<0	0.485 (0.038)		0.31 (0.499)	
p.value. (t.stat)	DAC≥0	0.076 (1,44)		0.354 (0.375)	

Where: N= Number of firm-year observations based on 117 firms (all outliers are trimmed).
 DAC=absolute discretionary accruals (excluding firm-specific variables). TAC=Absolute total accruals.
 CF=Cash flow from operations as computed within the model.

In panel B of Table 2, both the IFRS and LOCAL GAAP sub-samples report almost the same negative discretionary accruals (i.e., mean value of -0.046). In contrast, the POST SWITCHERS report a higher negative mean value (-0.057) than the PRE SWITCHERS (-0.049). Regarding positive discretionary accruals, the LOCAL GAAP sub-sample reports a higher mean value (i.e., 0.0499) than the IFRS sub-sample (i.e., mean = 0.039), but the POST SWITCHERS tend to perform less income-increasing earnings management (i.e., mean value of 0.051) than the PRE SWITCHERS (mean value of 0.056). The p-values indicate that the differences in absolute discretionary accruals between the various sub-samples are not significant at 1% and 5% levels.

Looking at earnings smoothing within this model, we consider the correlation between the absolute value of total accruals and operating cash flows as earlier discussed (see 4.2 above). The results are captured in table 3 below:

Table 3: Results; Analysis of Earnings Smoothing. Correlation between Accruals and Cash Flows.

A	Total Sample	IFRS	LOCAL GAAP
	Pearson Correlation (TAC-CF)	-0.649	-0.713
	(N)	473	243
B	SWITCHERS	PRE	POST
	Pearson Correlation (TAC-CF)	-0.677	-0.652
	(N)	78	79

Where: TAC-CF: Pearson Correlation coefficients of total accruals to operating cash. The results represent the total companies using IFRS or LOCAL GAAP (716 observations). SWITCHERS represents firm-year observations for companies that switch from IFRS to Swiss GAAP within the sample period.

The correlation coefficients in table 3 indicate that in general, companies reporting under Swiss GAAP smooth more reported earnings (-0.713) than companies reporting under IFRS (-0.649). However, the POST SWITCHERS report lower negative coefficients (i.e., -0.652) than the PRE SWITCHERS (i.e., -0.677).

The final steps to answer the hypotheses involve multiple regressions using the models specified above (see 4.2). The results in table 4 (both sections 1 and 2) indicate negative coefficients for IFRS (-0.001) which means that the companies reporting under Swiss GAAP are more associated with discretionary accruals than those reporting under IFRS. However, these results are not significant (i.e., t-tests of -0.96 and -0.91 for sections 1 and 2 respectively). panel B follows a similar trend regarding the association between IFRS and the magnitude of total accruals. Regarding the earnings smoothing measure, the interaction variable (IFRS*CF) indicates that companies reporting under IFRS are significantly more associated with earnings smoothing than those reporting under LOCAL GAAP (i.e., coefficients of 0.387 and 0.312, and t-tests of 3.548*** and 2.413*** for sections 1 and 2 respectively). Looking at the adjusted R², the model accounts for more than 90% of the variance in both discretionary accruals and total accruals and is a significant fit for the data (i.e., significance F = 0.000). Both discretionary accruals and total accruals are most significantly predicted by CF (coefficient of -0.934 with a t-stat. of -94.47) and ROA (coefficient of 0.957 with a t. stat. of 74.69 in section 1 of panel A). Section 2 presents similar results both in panels A and B.

Table 4: OLS Regressions; DAC & TAC

Variables	1. /DAC/		2. LN /DACC/	
	Estimated Coefficient	t-statistic	Estimated Coefficient	t-statistic

PANEL A: Magnitude of Discretionary Accruals

$$DAC_t = \beta_0 + \beta_1(IFRS_t) + \beta_2(CF_t) + \beta_3(LNASSET_t) + \beta_4(GEARING_t) + \beta_5(ROA_t) + \beta_6(INDU) + \varepsilon_{1t}$$

Intercept	0.038	15.44***	0.037	14.68***
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IFRS	-0.001	-0.96	-0.001	-0.91
CF	-0.934	-94.47***	-0.945	-93.49***
ROA	0.957	74.69***	0.968	73.83***
LNASSETS	0.0001	0.332	0.0002	0.55
GEARING	0.0011	0.916	0.00055	0.466
INDU	-0.00012	-4.357***	-0.0001	-4.148***

Continuation of table 10.

N	677	677
R ² (Adjusted)	0.9320	0.9308
Significance F	0.000***	0.000***

PANEL B: Earnings Smoothing.

Variables	Estimated Coefficient	t-statistic	Estimated Coefficient	t-statistic
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$$TAC_t = \beta_0 + \beta_1(IFRS_t) + \beta_2(CF_t) + \beta_3(IFRS_t * CF_t) + \beta_4(LNASSETS_t) + \beta_5(GEARING_t) + \beta_6(ROA_t) + \beta_7(INDU) + \epsilon_2t$$

Intercept	0.0058	2.516**	-0.0009	-0.333
IFRS	-0.0029	-1.838	-0.00153	-0.827
CF	-0.988	-101.801***	-1.0294	-89.392***
IFRS*CF	0.0387	3.548***	0.0312	2.413**
ROA	1.0083	99.73***	1.065	88.79***
LNASSETS	-0.00059	-2.0014**	2.223	0.0632
GEARING	0.0019	1.79	0.00011	0.0848
INDU	-0.000	-2.14**	-4.028	-1.264

1. /TAC/

2. LN /TAC/

N	716	716
R ² (Adjusted)	0.968	0.959
Significance F	0.000***	0.000***

Where: DAC=The absolute value of discretionary accruals as computed in the modified Jones model. TAC=Absolute value of total accruals. IFRS = Dummy variable: 1 if the company uses IFRS, otherwise 0. CF = Operating cash flow as computed within the model (i.e., EBIT-TAC). ROA = Returns on Assets (percentages). LNASSETS = The natural logarithm of total assets. GEARING = Ratio of long-term debt to equity in year t (or the GEARING ratio as provided in the ORBIS database). INDU = 2-digit NACE revenue code.

N = Number of firm-year observations. N-DAC is reduced to 677 observations because of further outliers detected (through the standardized residuals) and trimmed.

***, ** = Significant values at 1% and 5% levels respectively, two-tailed.

Section 2: LN /DAC/ and LN /TAC/ = The natural logarithm of discretionary accruals and total accruals after computing the Breusch Pagan test for Heteroscedasticity. Further details will subsequently be discussed.

Discussion and Conclusions

This research set out to investigate the influence of switching the reporting standards on the earnings quality of Swiss listed companies. To accomplish this, we examined the degree of accrual-based earnings management performed by companies reporting under Swiss GAAP as opposed to their counterparts reporting under IFRS. The fact that companies adopting Swiss GAAP report significant changes in their financial statements also led us to believe that these companies may perform higher earnings management after the switch as opposed to the prior periods when reporting under IFRS.

The use of well-recognized methods employed to compute accrual-based earnings management practices and to answer the research question yielded results that have led us to conclude against our initial belief. The main findings of the research suggest that on average, the firms under both standards are to some degree engaged in discretionary reporting practices, with Swiss GAAP being more connected to income smoothing. It also follows that prior to the adoption of Swiss GAAP, firms are more associated with earnings smoothing, but post adopt, they tend to more conservative accounting choices, as income-decreasing accrual-based earnings management is more common after the adoption of Swiss GAAP. However, the practices are not significantly different from those of their counterparts reporting under IFRS.

The findings of this research contribute to current discussions regarding the superiority of IFRS as a reporting standard when compared to country-specific GAAPs. Analogous to Van Tendeloo & Vanstraelen (2005) who base their studies on the German market, IFRS cannot be associated with higher reporting quality than Swiss GAAP, when looking at companies listed on the SIX stock exchange. This makes the drastic changes in the length of financial statements and the reduction in equity reported by companies that moved to Swiss GAAP between 2013 and 2014 as reported by Deloitte an interesting case.

The study also contributes to the recent assessments of varying models used to detect earnings management. While the modified Jones model remains a better model, the ROA-matched model seems to be more explanatory, yet more prone to heteroscedasticity as suggested by Dechow et al. (2012). It is clear from the study that different methods used to determine earnings management may yield divergent results.

Based on the findings, we recommend that auditors should familiarize themselves with various methods of discretionary accounting choices, as it may be difficult to detect earnings management which has a significant, yet unclear impact on the quality of reported earnings, as opposed to detecting fraud within the financial statements. Secondly, we recommend academic institutions to educate accounting students with measures of earnings management and the impacts of the practice on financial reporting. While researchers have taken extensive steps to enlighten users of financial statements regarding this practice, the academic sector needs to train students to avoid it. Even though earnings management respects the rules set by reporting standards, there is a thin line between the practice and accounting fraud, as both practices lead to misspecification of financial results.

In a final word, more Swiss-listed firms could benefit from moving to Swiss GAAP as the “true and fair view” principle makes it comparable with IFRS and the quality from an earnings management perspective is not substantially different from that of IFRS. Meanwhile, the companies stand to gain because they promote transparency by accounting in line with stakeholder needs and creating trust in Swiss financial reporting.

Like most studies, this research is not completely free from limitations. Although all necessary steps were taken to ensure that the models are correctly applied, the omission of income tax payable and debt in current liability as adopted from Burgstahler (2006) may lead to a deviation in the results, even if the sample is preserved. Secondly, the study shows some inconsistencies in detecting discretionary accruals, which always leaves possibilities of type I and type II errors. Also, the research follows other prior studies (e.g., Van Tendeloo & Vanstraelen, 2005) which immediately believe IFRS to be a benchmark for comparison of earnings quality, but do not look at the flipside which maybe that IFRS also provides opportunities for discretion which may sometimes be greater than those of other standards. In addition, it is acknowledged that other incentives for managing earnings may not have been controlled for within this study, although we have largely controlled for various incentives. Finally, the research, in line with Van Tendeloo & Vanstraelen (2005) only considers the quality of reported earnings in terms of earnings management. Based on these limitations, the following propositions are made: Further studies could replicate the present research but expand the sample to consider all firms in Switzerland, instead of being limited to companies registered on the SIX exchange. In this case, smaller firms are included in the study and the results would be true for a wider range of the population. Secondly, more aspects of earnings quality can be considered. In line with Barth et al. (2008), timely loss recognition and value relevance can be used as additional metrics to measure the quality of reported earnings.

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