THE 15TH EDITION OF THE INTERNATIONAL CONFERENCE
EUROPEAN INTEGRATION
REALITIES AND PERSPECTIVES

Study on the Relationship between the Normalised Accounting Model and Financial Risk

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Abstract: The adoption of **International Financial Reporting Standards** in 2005 by listed European firms, and accompanied by similar regulatory action across the globe, represents **one of the most influential changes of accounting rules** in the history. The transition from a set of own accounting principles to a single common set of accounting standards has affected thousands of companies that differ in terms of size, management structure, capital structure, culture, legal environment and other characteristics[2]. These changes had a great influence on **decision-making processes and risk management** thereby increasing the managers' concern about the predictive value of the **financial statements**[3].

Keywords: IFRS; accounting model; financial risks; financial statements; fair vakue; sensitivity analysis

JEL Classification: M41; G32

1. Introduction

IASB "was born from the desire and the need to share at international level the accounting experience specific to various countries, to harmonize cultural differences and socio-economic characteristics" that "load" "national accounting systems and to develop **a conceptual model consistency of financial statements**".[2] In the General Conceptual Framework for Financial Reporting, the IASB acknowledges and states, as a limitation of general financial reporting purpose, that it "does not provide and cannot provide all the information that existing and potential investors, lenders and other creditors need". Regarding the relevance of information, as a fundamental qualitative feature, the IASB states: "The Relevant financial information must have the capacity to generate a difference in decisions taken by users [..][3]. Financial information would have this capacity if "they have predictive value, confirmation value, or both of them". By definition, they have the predictive value of whether "can be used as entries in processes applied by users to predict future results", and do not in themselves represent a forecast or forecast. Also by definition, financial information has confirmation value if it "provides feedback on previous assessments".

The study conducted in 2010 and revised in 2012 namely "Does mandatory IFRS adoption improve the information environment?" shows that, the accuracy of the estimates and other measures of the IT environmental quality has been significantly improved as a result of the transition to International Financial Reporting Standards, especially for companies obliged to adopt IFRS than either for those who have voluntarily adopted or those who have not still adopted. The same study showed that the

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improvement of the IT environment can be attributed to **the quality of the information**, as well as to the increase of the comparability of the results[2]. At the same time, the increasing accuracy of estimates from mandatory adoption of IFRS is associated with the increasing opportunities for companies to manage the earnings nearly objectives.

2. Literature Review

The importance of financial risk management is highlighted by the International Standards, by issuing standards to help information users, due to the fact that in recent years the techniques for assessing and managing financial exposures have evolved. From their perspective we can say that the companies that apply them are also compelled to report quantitative and qualitative information related to certain financial risks to which they are exposed. The standard governing these requests is IFRS7 ***"Financial Instruments – Information to Be Provided"*** and entered into force from 1 January 2007, requiring comparison with a previous year.

IFRS 7– ***"Financial instruments: Information to be provided"*** applies to all risks arising from all financial instruments, with small exceptions.

One of its objectives is to "require entities to provide information in their financial statements that allow the users to evaluate: [...] the nature and extent of the risks arising from financial instruments to which the entity is exposed during the reporting period, as well as how the entity manages these risks."[2]
As referring to this standard the risks are included, but not limited to: **credit risk, liquidity risk and market risk.**

The standard allows the entity to make an analysis of the market risk sensitivity, using VaR or other own methods that reflect the interdependencies between risk variables. This sensitivity analysis is one of the crucial requirements imposed by IFRS 7. This includes a thorough analysis of the financial risks inherent in financial instruments, for each type of risk and its effects on profit or loss. The methods and assumptions used in the preparation of this analysis must be explained, and all the changes from the previous period and all reasons for the changes must be presented as well.

IAS 39 - ***"Financial Instruments: Recognition and Measurement"*** tackles the risk hedging by presenting instruments, components and accounting solutions. The risk hedging involves the designing of a derivative or non-derivative financial instrument, thus offsetting the changes in fair value or cash flows of the hedged item.

The requirements of international standards for reporting certain risk information (figure no. 1) are the result of changes in the quality of accounting information, especially regarding the increase of the accuracy of the estimates.

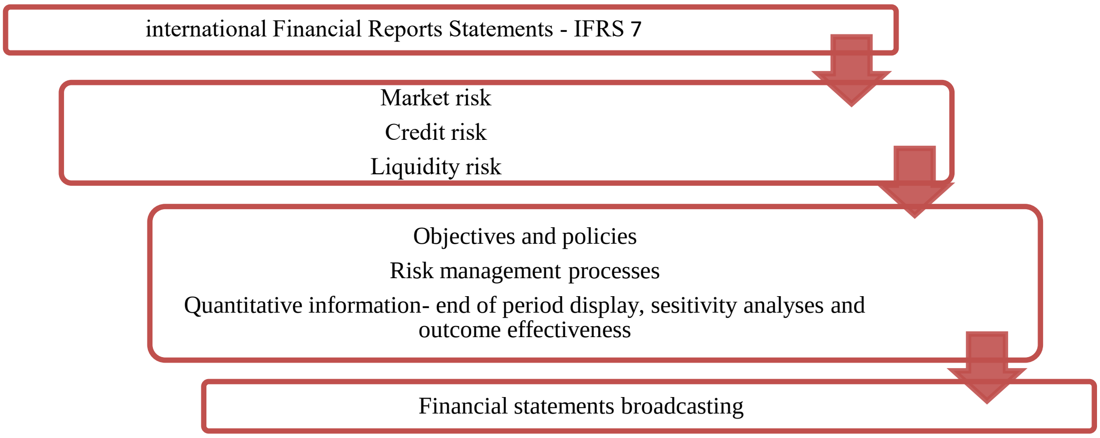

Figure 1. Risk Reporting in IFRS

Source: own processing.

We note that IFRS also considers credit and market risk analysis a priority, along with liquidity risk analysis. The purpose of the requests is to inform users of financial statements and to assist in the decision-making process. Providing adequate information might be very challenging for companies, as the annual reports represent the basic of broadcasting useful information meant to make decisions on investments, loans and other issues.

3. Research Methodology

All the information and ideas that have emerged from theoretical documentation led to **an empirical research** by using qualitative and quantitative methods.

Qualitative data analysis is an analysis tool used on a large scale of information research applications variety. In this study the research aimed to identify the ways of reporting financial risks within the normalized accounting model, by highlighting the types of financial risk, as well as the information related to them and presented in the annual reports. This was made possibile by analysing and observing the financial reports of 2018 for a group of companies that have implemented the International Financial Reporting Standards and have provided relevant conclusions regarding the risk reporting method.

4. Practical Case.

4.1. Strategic Analysis of the Teraplast Group

The Teraplast Group is one of the main suppliers for complete systems and solutions in the field of installations and constructions in Romania. The group board is as follows:

✓ Teraplast – the largest PVC processor in Romania;

✓ Plastsistem – produces sandwich panels and metal structures for trading and industrial constructions;

✓ Politub – produces polyethylene tubes for gas and water networks;

✓ TeraGlass – produces thermal insulating carpentry made of PVC and aluminium;

✓ Tera-Tools – produces moulds.

At the end of 2018, Teraplast's stake in Plastistem was 78.71%. The group owns 50% of the shares of a controlled joint venture called Politub S.A.

The company rumination assisted by SWOT analysis provides us information about the strengths and weaknesses of the organization, as well as the opportunities and threats that the external environment creates. By understanding external factors alongside with an examination of the activity helps to make an opinion regarding its activity, designing a tool for early stages of the decision-making process, and a precursor to strategic planning. The company's SWOT analysis led to the following results:

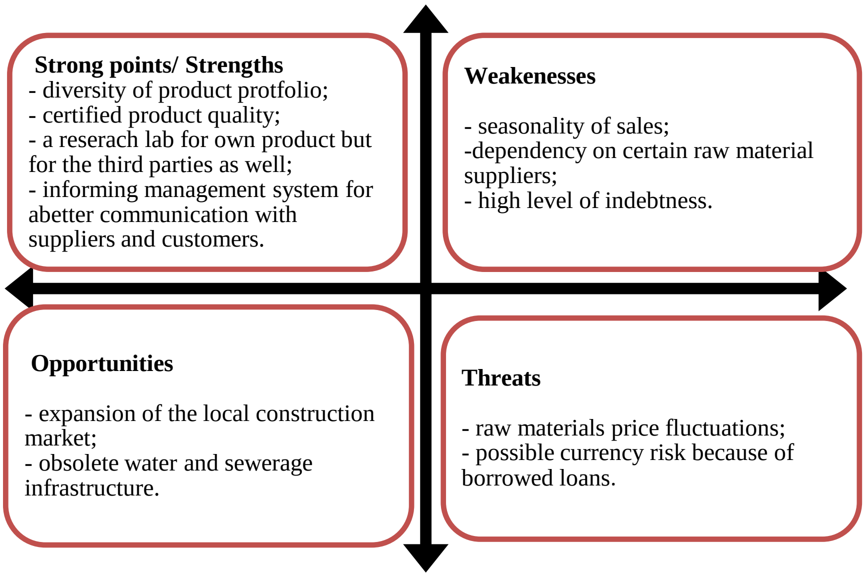

Figure 2. The SWOT Analysis of Teraplast Group

Source: own processing.

The SWOT analysis underlines a comprehensive picture of the internal values, as well as the critical points of the entity. Teraplast S.A. is a company with a broad product portfolio that meets the needs of different users. Having a constant concern for the highest quality standards in the manufacture of products, the company invests in its own research hub. In order to comply with European standards, the company's activity is carried out in accordance with the Integrated Quality-Environment-Health and Operational Security Management System according to SR EN ISO 9001:2008, SR EN ISO 14001:2005 and SR OHSAS 18001:2008 - SRAC Romania certified body.

Due to specifics of the products it manufactures, the company is dependent on certain suppliers of raw materials. This is a disadvantage because the supply is limited. The activities using the company's products can only be carried out at a certain time of year, which leads to the seasonality of sales. The investments and the projects in which the group is involved have forced the company to access more loans, increasing the degree of indebtedness. This is a weakness, especially if the associated risk is not properly managed.

Analysing the opportunities and threats it helps to understand the broad context of the group activity. One of its opportunities is the expansion of the local construction market, and especially the fact that the infrastructure for the supply of water and sewerage is obsolete and requires replacement.

The price fluctuations of the raw material adversely affect the company's activity, their forecasting being difficult to be performed in accordance with company's strategy. The loans contracted in foreign currency increase the market risk to which the company is exposed and the exchange fluctuation rate may have a negative impact on the result.

The analysis and the preliminary information about the company show us an ever-growing company concerned with providing good service to its customers. The management is interested in the company's well-being, and the effective risk management is considered as a prerequisite for this.

4.2. The Organisation of Accounting, Principles and Methods Used within Teraplast SA Group

Teraplast S.A. Group is a listed company that produces **consolidated financial statements in accordance with International Financial Reporting Standards** as well as with updated O.M.F. no. 1121/2006. According to their requirements, the financial statements include the following[2]:

- Consolidated statement of financial position;
- Consolidated statement of revenue and expenditure;
- Consolidated statement of global outcome;
- Consolidated statement of own equities changes;
- Consolidated statement of cash flows.

All the statements are drafted in the Romanian language and are presented in RON currency, using the principle of **business continuity**. At the same time, an important feature is the fact that the consolidated financial statements were prepared taking into account the **historical cost** with small exceptions (such as the reassessment of certain fixed assets, financial instruments).

The consolidated financial statements encompass the financial statements of the parent company, the subsidiaries and the joint venture. Where necessary, there are checked the subsidiary's financial statements to bring its accounting policies in line with those used by the group, and the transactions within the group are completely eliminated by consolidation.

From the IASB point of view, the accounting principles are interpreted as follows[2]:

- If the financial statements meet the shareholders' need, a preference given to shareholders' views proves that they satisfy most other users as well;
- More economical information with more systematic application, based on the principle of reality prevalence on appearance and a clear orientation towards measuring performance;
- More transparent information to cut the possible accounting choices, for an almost systematic recording of the items stipulated in the balance sheet and beside it for providing more details.

The Teraplast S.A. Group makes use of these **accounting principles**, following the adoption of international accounting standards. The purpose of the consolidation of accounts is to present the financial statements of a group of companies forming a single economic entity. There are several consolidation methods, as the company analyzed is using the method of equivalence for the financial statements of Plastsystem S.A. due to the notable influence of the parent company, and the method of proportional integration, due to the fact that Politub S.A. is under the control of other shareholders at the same time as well.

The explanatory notes of the financial statements contain information about standards, amendments and their new interpretations. This part outlines the changes in accounting policies and information in order to be provided, as well as the IFRS standards that have been adopted by the company for each financial year. There are also outlined both the issued but not yet adopted standards and the main accounting policies for drawing up the 2018 consolidated financial statements.

4.3. The Analysis of Key Points for the Financial Statements of the Teraplast S.A Group.

The analysis of the key points consists in studying the financial statements of the group to highlight the strengths and weaknesses. The wholistic picture of the company cannot be assessed only by using this method, but it does provide us an important information regarding its position and financial structure.

Table 1. summarizes the main financial information stipulated in the *consolidated statements of the financial position and global outcome* and this is useful in the calculation of certain indicators.

Table 1. The Analysis of Financial Structure and Position for Teraplast SA Group

	2016	2017	2018	% 2017 vs 2016	% 2018 vs 2017
Intangible assets	304.246	1.587.399	1.328.431	422%	-16%
Tangible assets	171.792.642	153.177.918	158.518.944	-11%	3%
Financial assets	1.830.405	16.400	12.273.735	-99%	74740%
Total turnover	**173.927.293**	**154.781.717**	**172.121.110**	**-11%**	**11%**
Supply	32.248.909	39.991.143	42.235.697	24%	6%
Debts	76.213.324	70.863.288	87.649.038	-7%	24%
Liquidities	3.562.601	4.292.938	8.893.019	21%	107%
Total current assets	**112.024.834**	**120.612.934**	**139.055.129**		
Commercial debts	69.167.574	63.968.584	78.021.966		-100%
Short-term credits	58.848.869	47.751.892	69.892.609	8%	15%
Short-term debts	**131.347.613**	**111.720.476**	**147.914.575**	**-8%**	**22%**
Long-term credit	18.214.443	38.643.383	22.803.525	-19%	46%
Long-term debts	**20.508.197**	**42.558.314**	**27.869.574**	**-15%**	**32%**
Share Capital	60.817.598	60.817.598	60.817.598	112%	-41%
Reserves	6.771.814	6.906.225	36.192.354	108%	-35%
Reported outcome	20.632.060	7.646.736	(7.732.071)	0%	0%
Minority interests	3.629.726	4.053.374	3.878.467	2%	424%
Equity	**134.096.316**	**121.669.051**	**135.401.466**	**-63%**	**-201%**
The outcome before taxation	**(7.921.177)**	**(11.810.382)**	**(16.968.280)**	**12%**	**-4%**
Financial outcome	**(8.304.249)**	**(12.181.566)**	**(14.338.031)**	**-9%**	**11%**
Economic yield	-2.8%	-4.3%	-5.5%	49%	44%
Financial return	-6.2%	-10.0%	-10.6%	47%	18%
Inventory turnover	9	8	8		
Debts turnover	4	4	4		

Source: own processing.

By evaluating the evolution of the company's assets in the last 3 years, we note that the turnover holds a significant share of total assets (61% in 2016, 56% in 2017 and 55% in 2018). During the revised period, they did not show any significant increases or decreases.

In terms of claims, we note that they represent a significant part of current assets (68% in 2016, 59% in 2017 and 63% in 2018). The calculated rate of claims turnover (rotation) is 4 days, which is constant for the revised period.

The share of short-term debt increased in 2018 as compared to 2017 by 30%, after a 15% decrease in 2017 compared to 2016. Commercial debts constitute a significant part of them.

He performance of the total assets was calculated using the economic rate of return, through the ratio Gross profit / Total assets. This has a negative value due to the fact that at that time the company records losses.

4.4. The Financial Risks Analysis of Teraplast S.A Group

Comparing with the classical analysis of a company that takes in a national accounting model, there are emphasized certain particularities of the financial risks analysis within a group as well. As the group has no legal personality, it was analyzed the risk of each entity within the group and this resulted in spotting the impact that the identified values have on the group.

The group comprises the parent company, Teraplast S.A., and two subsidiaries Plastsistem S.A. and Politub S.A. The risks related to each entity have implications depending on the weight of the shares held. Hence, all the risks of the parent company spread over the group, while the risks to which the jointly owned unit, Politub S.A., is exposed, affect to a lesser extent the results of the group.

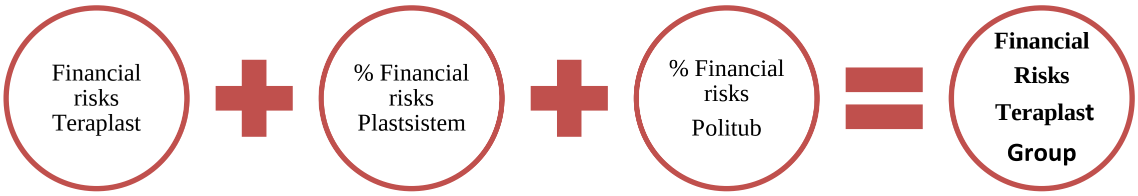

Figure 3. The Influence of the Subisidiaries' Financial Risks on the Group

Source: own processing

The parent company Teraplast S.A. has drawn up financial statements in accordance with IFRS for the first time for 2018, in accordance with the updated OMFP 1286/2012[2] for the approval of the Accounting Regulations as well as in accordance with the International Financial Reporting Standards and there are applicable to companies whose securities are admitted to trading on a regulated market. Taking into account the IFRS regulations, the company has reported the following: **the overall income statement, the financial position statement, the statement of changes in equity and cash flows, as well as notes to the presented financial statements.**

The situation of the global result is the equivalent of the profit and loss account from the national regulations.**According to the IASB,** the outcome from profit and loss account does fully highlight neither the company performance nor its results, and as a consequence, there has been introduced a new demand on presenting a primary financial statement of those neglected current gains and losses (Tabără & Roxana, 2007, p. 268).

According to **IASB requirements**[3] this presentation must provide at least the following information about: income, gains and losses arising from the derecognition of the financial assets measured at depreciated cost level, financial costs, the profit share or losses of the associated entities and joint ventures, as there are bookkept using the equivalnce method in case of financial asset reclassification by a fair assessment, any kind of profit or loss caused by the difference between the previous book keeping value and its current real value issued at the date of reclassification, the taxation, a single amount comprising the total profit or loss after taxation from discontinued activities, each component of other global result elements classified by nature, the part of other global results joint entities as accounted by the equivalence method, and the entire global result.

The statement of financial position is the balance sheet equivalent of national regulations. Therefore, the information contained therein is of real use in the risk analysis, together with the information in the statement of the global result. These two financial statements create the basis for the analysis of financial risks.

Analogue to the model of an analysis for national accounting, the rates of financial profitability of equity, the rate of financial return on permanent equity and the financial leverage were calculated. The peculiarity of calcualtion lies in the fact that the useful information in this analysis is not all available in the financial statements submitted by the company, but we find it detailed in the notes related to them (e.g. operating income, total revenues).

The calculation results for these data are pointed out in the table no.2.

Table 2. Financial Leverage for Teraplast S.A. Group

	Formula	2017	2018
Economic yield	**Exploiting result/ At**	**-5.9%**	**-1.8%**
Average interest rate (i)		5.4%	5.4%
Financial return	**(Pn/Cpr)**	**-12.8%**	**-8.5%**
Financial leverage		**-1.6%**	**-2.6%**

Source: own processing.

The financial leverage is a financial management technique and herein highlights the relationship between the rate of financial return and the rate of economic profitability. It reflects on influencing the loans and profitability interests. The effect generated by indebtedness causes the change level of financial profitability in the sense of its increase or decrease, depending on the level of economic profitability as compared to the average cost of debt.

As a consequence of company losses, the values of economic and financial profitability are negative. The leverage is negative, which means that the company does not get a decent return to bear the costs of the debts from the exploitation of the assets it has on disposal. **The increasing indebtedness leads to a decrease in financial profitability.**

The breakdown of financial profitability into influent factors shows that the slight increase recorded in 2018 and compared to 2017 results from the increase in the speed of assets turnover (by about 12%), but also from the multiplication factor (by about 11%). Net profit at 1leu revenue is slower in 2018 compared to 2017.

These results have led us to the conclusion that society must make efforts to improve its financial performance by increasing the efficiency of resource use. Leverage analysis is important in determining the strategy to minimise financial risk.

The financial balance of a company is a function of coherence between needs and resources. This consistency is determined by the solvency and liquidity of the company. Within the national accounting model, the financial balance is traditionally assessed by studying the relationship between the revolving fund, the working capital requirement and the treasury. The same approach can be found at the level of the international accounting model.

We aim to calculate these indicators for the company under analysis.

Table 3. Working Capital Calculation at Teraplast S.A.

	2017	2018	% 2018 vs 2017
Equity	121.772.850	114.259.853	-6%
Medium and long term debts	19.100.859	44.292.425	132%
Permanent capital	140.873.709	158.552.278	13%
Permanent assets	168.083.242	150.198.059	-11%
Working capital	**(27.209.533)**	**8.354.219**	**-131%**

Source: own processing

There was a negative bearing fund for 2017, and a positive one for 2018. Significant increase in long-term debt (by 132%) is the main factor in its positiveness. The negative bearing fund leads us to the conclusion that some of the fixed assets were financed from short-term loans in 2017, and with the debt contraction in 2018 the permanent capital was increased and led to a positive revolving fund.

The global confrontation of the financing needs of operating activities with the actual means of financing leads to the revolving fund requirements. The financing needs determined by the operating cycle correspond to the funding advances that the company must attribute to the stock formation, the granting of payment terms to the trading partners. The need for a working capital is determined by taking into account the short-term elements of the asset and the liabilities. Calculations of the revolving fund requirements as well as of the treasury for the analyzed company revealed the following figures:

Table 4. The Working Fund Requirement and the Net Treasury for Teraplast S.A.

	2017	2018	% 2018 vs 2017
Working capital	(27.209.533)	8.354.219	-131%
Necessary working capital	(15.990.763)	13.365.894	-184%
Net treasury	**(11.218.770)**	**(5.011.675)**	-55%

Source:own processing.

As we have seen, the components of the working capital requirement are related to the company’s current activity, namely the operating activity, and the components of the treasury are related to the short-term financial company operations. **The net treasury** also registers negative values in 2017 and 2018, which means that the company is dependent on short-term financial resources. These negative values express a financial dependence, but should not be interpreted as a symptom of insolvency. We believe that these indicators would be useful to present in the company’s financial reports to help investors and other stakeholders A clearer opinion on the company’s situation is made by linking the results obtained with the **liquidity** and **solvency** indicators.

Liquidity indicators measure the company’s ability to meet its short-term obligations, and solvency indicators reflect the extent to which it can effect payment obligations, mainly from its own sources. The degree of indebtedness calculates the proportion in which the total asset is financed from sources other than its own. In our case these indicators are presented as follows:

Table 5. Liquidity and Solvency Indicators for Teraplast S.A.

Indicators	Calcuation Formula	2071	2018
Current Liquidity	*(Assets-stocks)/Short term Debts*	0.81	0.71
Solvabilitate generală	*total Assetst/Total Debts*	2.06	1.93
Gradul de îndatorare	*Total Debts/total Assets*	48%	52%

Source:own processing.

The higher **the current liquidity** value the greater the ability of the company to pay its debts, without resorting to other loans. We note that the values obtained for the parent company of the group are lower than 1, with a small decrease in 2018 compared to 2017. This decrease is mainly due to an increase in the value of current assets caused by a 25% increase in commercial claims, but also by short-term debt by 20%.

The general solvency indicates the possibility of covering total liabilities with assets, and a value as close as 2 is considered ideal. We note that this requirement is met by the company. A high degree of risk is revealed by the degree of indebtedness. The values recorded for the two years under analysis are around 50%. These figures were obtained using the formulas in the specialty literature (Total Debts/Total Assets). According to the notes to the company's financial statements, the company calculated this indicator according to the formula Net Debt/Total Capital. Net debt represents long-term and short-term total loans without cash and cash equivalent. Under this formula, the debt level is 33% in 2018 and 35% in 2017.

All the analyses carried out above lead us to the conclusion that the parent company of the group is subject **to a rather high financial risk**, especially with regard to indebtedness. In order to get a complete idea of the financial risks, the company is also interested in the information provided by the company on how to manage them through the financial statements, as provided for in **IFRS**.

The market risks the company is primarily exposed to are the risks of the foreign exchange rate and interest rate. **According to IFRS**, the company has prepared **sensitivity analyses** to show the impact that changes in values would have on the outcome.

According to the annual report, the company monitors exposure to interest risk by simulating various scenarios, including refinancing, updating existing, alternative funding positions, estimating the potential impact on the profit and loss account of fluctuations. Maintaining a balance between fixed-rate and fluctuating loans is one of the ways of managing this type of risk. An interest rate swap contract was also concluded and on 31 December 2018, its fair value represents a loss of 281,340 lei.

In the event of a 1% increase/decrease in the interest rate on loans, the other conditions remaining constant ,the net profit would fluctuate with the values shown below, as a result of higher/low interest expense on variable interest loans.

Table 6. Analysis of Sensitivity to Interest rate Fluctuations in Teraplast

	31 December 2018		31 December 2017	
Profit/loss	650.777	(650.777)	669.908	(669.908)

Source: Annual ReportTeraplast S.A.

The exposure to currency risk is another risk to which the company is exposed. The company's sensitivity to a 10% increase/decrease in the euro compared to ron can be seen in the table below.

Table 7. Analysis of Sensitivity to Exchange rate Fluctuations at Teraplast

	31 December 2018		31 December 2017	
Profit/loss	(8.755.260)	8.755.260	(8.124.874)	8.124.874

Source: Annual ReportTeraplast S.A.

Regarding the credit risk, the company has adopted a trading policy only with trusted parties, along with certain guarantees to reduce the risk of financial losses from non-compliance with contracts. Commercial claims consist of a large number of customers, from various geographical areas and industries.

5. Conclusions

We believe that the details provided by the company related to the financial risks imposed by **IFRS** provide users of financial statements with a guarantee that management is aware of **the risks** to which it is exposed and the impact they may have on the business. The more complex the details provided, the more detailed the reality is, the higher the assurance. From the analyzes performed, as well as from the details provided by the company, we conclude that Teraplast S.A. is a company moderately exposed to financial risks, due to its involvement in their efficient management. As this company is the parent company and the implications for the group are 100%, all these identified and evaluated risks are totally affected by the results of the Group.

Plastsistem company is a company where the group owns a 78.71% stake. Thus, we consider that the financial risks associated with this entity affect the activity of the group. The financial statements of this company are not available on its official website, but we used the information available on the website of the Ministry of Public Finance and we tried to make an assessment of the financial risk.

The group report refers to a loan requested for an investment in this subsidiary (until its settlement through European funds), a loan that led to the increase of the group's debt by 12,286,336 lei compared to the previous year. This credit led to 38% increase in the group's indebtedness, indicating a moderate dependence on the financing banks. Using the formula from the specialty literature, a very high degree of indebtedness (about 72%) was identified in the year 2018 of Plastsistem, slightly increasing compared to 2017 (65%). These values can affect the continuity of the company's activity, with implications on the group results.

According to the gathered information, the company registered a loss of 720,840 lei in 2018. The jointly owned unit, Politub S.A. deals with the production of polyethylene pipes for the transport and distribution networks of water, natural gas, but also telecommunications. The Group reports in the consolidated report the amounts included in the financial statements as a result of the proportional consolidation. The debt ratio is high for this company (48% in 2018, 52% in 2017). It can be seen that the debts registered by each of the companies have an impact on the debt level of the group. It was 38% in 2018 and 41% in 2017. Regarding the market risk, the Group presents in its annual report **the sensitivity analyses** on the exchange rate fluctuation and the interest rate. We can conclude that **the risk analysis** within a group is limited to the risk analysis of each component entity, thus being able to identify the necessary steps to be taken for the activity improvement. The financial risk assessment of the whole group provides an overview and the causes can be identified only in case of individual analyzes.

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