
Prudence vs. Credibility. A Formal Comparative Analysis between Romanian Accounting Regulations and IFRS

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ABSTRACT

Starting from the controversial influence that prudence may have on the credibility of accounting information and from the fact that there are different views of the global accounting systems on this concept, the present research aims to analyze the level of formal convergence between the Romanian accounting regulations and the International Financial Reporting Standards (IFRS) on the application of prudence. In this regard, the requirements for provisions, property, plant and equipment, inventories and receivables were considered, with a focus on asset depreciation and impairment losses, elements that were considered in this case as being representative for prudence in accounting. Using the Jaccard coefficients, the paper compares the requirements of the Romanian accounting regulations, represented by OMFP no. 1802/2014 with the ones presented in IAS 16 „Property, plant and equipment”, IAS 36 „Impairment of Assets”, IAS 38 „Intangible Assets”, IAS 37 „Provisions, Contingent Liabilities and Contingent Assets”, IAS 32 „Financial Instruments: presentation” and IFRS 9 „Financial Instruments”. The results show that the highest degree of convergence is identified for the provisions, and the lowest for financial assets. Also, the requirements on depreciation and impairment losses presented in OMFP no. 1802/2014 differ significantly from those presented in IFRSs.

Keywords: Romanian accounting regulations, IFRS, similarity, convergence, accounting policies

JEL Classification: M41, M48

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Introduction

Globalization has intensified unprecedentedly in the recent years, being considered, perhaps, the most important economic process that marked the end of the millennium. After nearly 50 years in which „three different worlds” co-existed: countries with developed economies, with developing economies and those with a hyper-centralized economic system, these worlds have come closer, barriers between them being reduced. Their national economies have become more and more interconnected within the international economic system and have gradually come to a global economic system where economic interdependence between countries is considered to be an essential element (Olaru and Olaru, 2009). In terms of accounting, the two dominant accounting systems (the Anglo-Saxon and the Continental one) exerted a strong influence on national accounting systems that showed significant differences. These differences generated many concerns regarding an unique reporting framework. Under these conditions, international accounting harmonization has become necessary, with the aim of eliminating differences in financial reporting between countries, being increasingly demanded by investors, especially foreign ones who needed to compare, by equivalent criteria, the opportunities for capital placement. The start of the international accounting convergence process took place in October 2002 when the FASB and the IASB announced the signing of a Memorandum of Understanding called Norwalk Agreement, an act that will remain in the history of international accounting as a compromise made for the adoption of some compatible solutions for problems related to accounting treatments (Dima Cristea and Șărămăt, 2011, p. 3).

In the context of the current economy, the decision making process is dependent on the quality and the quantity of information provided by companies. At the same time, accounting information results from primary accounting data, processed by accountants. Given the mere fact that human resources are implicated it is subjected to a high degree of subjectivity. When referring to subjectivity in accounting, we must consider the prudence principle. It requires accounting information to be pessimistic, to ignore unrealized gains and asset gains, and to consider losses and the rise of real or potential debts. This concept is found in every country's accounting regulations and pursues the same idea everywhere: to provide a safety margin for society

and users of financial information (Toma 2001). It induces the idea of legal protection, meaning that it protects tomorrow's owner from an expense that belongs to today's owner and avoids decapitalization of the firm, which may occur in response to the distribution of unrealistic benefits (Horomnea 2013). It also prohibits the overstatement of a company's assets and income and the understatement of its liabilities, expenses and equity, and implies taking into account potential losses, risks and impairments, without leading to the creation of hidden reserves or oversized provisions.

In IASB's view, the Conceptual Framework for the Preparation and Presentation of Financial Statements, issued in 1989, presented prudence between the qualitative characteristics of the financial statements, more precisely as a component of credibility. Its review in the years that followed, with an emphasis on the 2010 version, has produced a number of major changes, including the exclusion of prudence on the grounds that it disagrees with neutrality and that it is not an universal characteristic, which applies to all the standards. In order to eliminate this inconvenience and to meet the demands of those that opposed to the exclusion of prudence from the Conceptual Framework, in the March 2018 version of the Framework, the Council reintroduced prudence in close correlation with neutrality. Thus, in the current version, it is specified that: „neutrality is supported by the exercise of prudence” (point 2.16 IASB, 2018) and that its exercise does not imply an informational asymmetry, the latter not being a feature of useful financial information. Mihalache (2016) emphasizes that prudence is reflected in UK accounting regulations, as in the 1989 version of the IASB's Conceptual Framework, among the requirements needed to ensure the credibility of financial information.

In FASB's (Financial Accounting Standards Board) view, unlike IASB, prudence was not seen as a component of credibility but it was considered necessary, being a reaction to the uncertainty that exists in the economic system.

The Continental accounting system, closely related to the Romanian accounting system for a long time, is oriented towards taxation and the use of the banking sector as the main user, the financial markets being still in an early stage. In these circumstances, the accounting was over-directed towards prudence (Bebeșelea, 2016), this principle being considered of vital importance and also a precaution for creditors.

Starting from the importance of the International Financial Reporting Standards proposed by the IASB in the process of harmonization at international and national level, we considered necessary to analyze how prudence is addressed in the international accounting referential and in Romanian accounting regulations, prior to conducting an analysis of material convergence (*de facto*) on this subject. Jaccard coefficients will be used for this purpose, this method being the most used and recommended in the international literature as it provides a much more credible basis for evaluation compared to other existing methods for analyzing the degree of formal convergence (*de jure*) between certain sets of regulations (Fontes, Rodrigues, & Craig, 2005, p. 417).

Referring to International Financial Reporting Standards, it can be argued that they address the issue of prudence in terms of the effects of its application, exercised over the various elements included in the financial statements. As seen from the perspective of the national regulations, Ionașcu and Feleagă (1997, p.372) identify the place of prudence from an operational point of view in the valuation process, namely in the valuation of elements at the end of the financial year and their presentation on the balance sheet, as presented in the current national regulations (MFP 2014).

We propose, in the following, to present: the current state of the field regarding the analysis of convergence between different sets of regulations (first section), the methodology applied in the undertaken analysis (second section), the analysis of the results and the identification of the main factors that have led to the appearance of differences between regulations (third section), as well as the conclusions and the limits of the study (last section).

1. Literature review

The accounting literature on the formal convergence between different sets of regulations is based mostly on the work of Rahman, Perera and Ganeshanandam (1996) and that of Fontes et al (2005). This section aims to create an image of the research on formal convergence both at the international literature level, referring to the most cited papers, as well as at the level of the Romanian academic environment.

A first paper belonging to Rahman, Perera and Ganeshanandam (1996) introduced a methodology for

measuring formal harmonization between countries, targeting the case of Australia and New Zealand. The study involved a comparison of the requirements applicable to listed companies by focusing on presentation, disclosure and measurement. For this analysis the requirements of the standards were divided into four types: type 1 (required for all listed companies), type 2 (recommended or suggested), type 3 (permitted), or type 4 (not allowed). The method used by the authors was Multiple Discrimination Analysis (MDA), the purpose of which was to measure the level of formal harmonization between the two countries' accounting regulations. The results of the study highlighted the usefulness of the method and served as a model for many other researchers. Garrido et al. (2002) developed a methodology for measuring formal harmonization that could be used to analyze the degree of comparability between different sets of regulations at different times or even between different countries. The authors provided a method for measuring the progress of IASC on formal harmonization, based on three historical stages in the development of the standards: 1973-1988 (Stage A), 1989-1995 (Stage B), 1995-present (stage C). The analyzed sample contained the accounting treatments included in the International Accounting Standards (IAS) which have been modified over the existence of the IASC. The authors divided them into four categories in a similar manner to the methodology applied by Rahman, Perera and Ganeshanandam (1996), as follows: „requested”, „reference”, „allowed”, and „forbidden”. The results were obtained using the Euclidean Distance Method and indicate that the IASC has made significant progress regarding the comparability of financial information.

Fontes et al (2005) studied the comparison between a set of national accounting standards (for the case of Portugal) and IAS / IFRS. The author proposed three methods for measuring formal harmonization, namely Euclidean distance, Jaccard coefficients and Spearman coefficients. The analyzed sample included a number of IAS / IFRS accounting requirements, and the results indicated a high level of convergence between Portuguese and International Financial Reporting Standards. After applying all three methods the authors' recommendation was to use Jaccard's coefficients because this method provides a much stronger basis evaluation compared to the other proposed methods.

The study of Ding et al. (2005) investigated the degree of convergence between national accounting standards for a sample of 30 countries and the IAS, using two indices: the absence index (to quantify the extent to which certain accounting rules are not found in the National Accounting Standards, but they are covered by IAS) and the divergence index (which covers rules related to the same accounting item, but differ in the two sets of standards). Additionally, through a regression, the determinants of absence and divergence for the analyzed sample were identified.

Strouhal (2009) focused on the degree of convergence between Czech accounting standards and IFRSs through Jaccard's similarity coefficients. The results of the study indicate a high degree of convergence between the two analyzed sets.

Qu and Zhang (2008) studied the convergence between Chinese accounting standards and IFRS, using fuzzy clustering method. The results of the study showed a high degree of convergence between the two sets of standards. Another study that focused on the convergence of Chinese standards with IAS / IFRS, this time using a longitudinal analysis for the 1992-2006 period of time, belongs to Peng and van der Laan Smith (2010). For the analysis, the Chinese accounting standards were compared with IFRS and a convergence score for each item analyzed was established using three categories: „total convergence”, „substantial convergence” or „non-convergence” with IFRS.

Baltariu and Cârstea (2012) analyze the degree of formal accounting harmonization within the European Union regarding EC Regulation no. 1606/2002 adopted by the European Parliament and the European Council on 19 July 2002, which regulates the IFRS application for the financial reporting of listed European companies. For this purpose, Rogers and Tanimoto coefficients, Lance and Williams coefficients, the Euclidean distance coefficient and Jaccard's coefficients were used. The results confirmed the hypothesis according to which: the degree of similarity is higher between the Romanian accounting system and the accounting systems of the countries that belong to the continental accounting system and is smaller between the Romanian accounting system and the accounting systems of the countries that belong to the Anglo-Saxon system.

Gîrbină et al (2012) presented a comparative study between Romanian national regulations and IFRS for SMEs in order to determine the differences and similarities between the two sets of regulations, using four indices: the modified Jaccard coefficient, the

absence index, the divergence index and the average distance.

Albu and Pălărie (2016) analyzed the level of convergence between Romanian accounting regulations and IFRS (IAS 16, IAS 17, IAS 41 and SIC 15) over a period of ten years. The authors assigned scores such as: „1 for full convergence” and „0 for complete difference”, in order to measure the level of convergence between the requirements of both standards. The results showed that in 2005 there was a high level of convergence for property, plant and equipment, medium level of convergence for leasing and divergences for agriculture. The analysis also revealed that the level of convergence has improved over time, but there is still room for more.

2. Research methodology

In order to determine the degree of formal convergence between Romanian accounting regulations and IFRS (with emphasis on IAS 16, „Property, plant and equipment”, IAS 36 „Impairment of Assets”, IAS 38 „Intangible Assets”, IAS 37 „Provisions, Contingent Liabilities and Contingent Assets”, IAS 32 „Financial Instruments: Presentation” and IFRS 9 „Financial Instruments”) with respect to prudence, we used a methodology based on Jaccard coefficients, calculated using the following formulas:

$$S_{ij} = \frac{a}{(a+b+c)}$$

$$D_{ij} = \frac{(b+c)}{(a+b+c)} \text{ where,}$$

S_{ij} - Jaccard's similarity coefficient, which is the extent to which the sets of regulations i and j are similar;

D_{ij} - Jaccard's distance coefficient, which is the extent to which the sets of regulations i and j are different;

a - the number of elements found in both sets of regulations;

b - the number of elements that are found in the set of regulations j , but are not found in the set of regulations i ;

c - the number of elements found in the set of regulations i , but not found in the set of regulations j .

The Jaccard's similarity and distance coefficients values are complementary, their sum being always equal to 1. The closest the coefficient of similarity is to 1, the higher the degree of convergence between the two sets of regulations.

To begin with, in order to establish the degree of formal convergence between national accounting regulations and IFRS, we analyzed the assets that require the use of impairment losses and depreciation, and the provisions, which are consistent with the prudence principle. Thus, we analyzed the requirements for recognition, valuation moments, types of values and other items attributable for the following: provisions, property, plant and equipment, intangible assets, inventories, accounts receivables and short-term investments.

In OMFP 1802/2014, the valuation of assets and liabilities is presented on several levels: first, in a separate section, the general valuation rules are established, after which, for assets and liabilities, details are presented in the sections reserved for each category (Istrate, 2018). Three aspects of the assessment are taken into account in the Romanian

accounting: the valuation at entry, the valuation at inventory and the presentation in the balance sheet and at the retirement or disposal moment. In IFRS we do not find a distinct section that presents the general valuation rules and there is no delimitation of the moments presented in OMFP 1802/2014. This is why, for the selection of the elements analyzed to determine the degree of convergence, we took into account both the national accounting regulations and IFRS regulations.

3. Results and discussions

The comparative analysis undertaken in order to establish the degree of convergence between the two sets of regulations for the selected categories is presented in **Table no. 1**.

Table no. 1. Formal accounting convergence - analyzed categories		
Category / Element	OMFP 1802 vs. IAS / IFRS	
	OMFP 1802/2014	IAS/ IFRS
Intangible assets		
Recognition	1	0
Entry	1	1
Amortization	0	1
Impairment	0	1
Presentation and disclosure	0	1
Property, plant and equipment		
Recognition	1	1
Entry	1	1
Amortization	0	1
Impairment	0	1
Presentation and disclosure	0	1
Inventories		
Recognition	1	1
Entry	1	0
Impairment	1	1
Presentation and disclosure	0	1
Retirement or disposals	1	0
Provisions		
Recognition	1	0
Changes in provisions - creation	1	1
Changes in provisions - increase	0	1
Changes in provisions - decrease	1	1
Use of provision	1	1
Reimbursement	1	1
Presentation and disclosure	0	1

Category / Element	OMFP 1802 vs. IAS / IFRS	
	OMFP 1802/2014	IAS/ IFRS
Financial assets		
Recognition	0	1
Entry	0	1
Impairment loss	0	1
Financial assets classification	0	1

Source: Authors' compilation

The values of the Jaccard coefficients for the analyzed categories can be found in **Table no. 2**.

Table no. 2. Jaccard coefficients for the analyzed categories		
Category	Jaccard coefficients OMFP 1802 – IAS / IFRS	
	Sij	Dij
Property, Plant and Equipment	0,20	0,80
Intangible assets	0,40	0,60
Inventories	0,40	0,60
Provisions	0,58	0,42
Financial Assets	0	1

Source: Authors' compilation

For the first two analyzed categories, **property, plant and equipment** and **intangible assets**, a first difference that can be identified follows the recognition of these assets (as can be seen in Table no. 1). Thus, analyzing the requirements presented in OMFP 1802/2014, it is observed that the scope for *property, plant and equipment* is more extensive than IAS 16, the Romanian regulations including, in this category, a series of assets for which are applied the accounting treatments that fall within the scope of other standards (for example, the IFRS 5 „Non-current assets held for sale and discontinued operations” or investment property covered by IAS 40 „Investment property”).

For the second category, **inventories**, accounting policies presented in OMFP 1802/2014 are applied to assets that fall within the scope of other international standards (as it is the case for a set of assets that fall under IAS 41 „Agriculture”). Although the requirements of IAS 2 „Inventories” have been mostly taken over in national regulations, some differences remain, particularly in the valuation chapter, which have not been totally converged. Thus, it was noted that IAS 2 does not distinguish between different types of discounts, all of them reducing the acquisition cost. In

both sets of regulations, end-of-year inventory valuation is made at the minimum between the cost and the net realizable value. The net realizable value results from the estimated selling price that could be obtained during the normal course of a business less estimated costs for completion of the asset, where applicable, and the estimated sales costs. If the book value is greater than the inventory value, the inventory value decreases to the net realizable value by creating an impairment adjustment. The last difference is attributed to the methods that can be applied when removing fungible stocks from the inventory. In this respect OMFP 1802/2014 allows the LIFO method (last in first out), a method that is forbidden by IAS / IFRS.

For **provisions**, it can be seen that between OMFP 1802/2014 and IFRS (focusing on the IAS 37) there is a high degree of convergence (58%). A first difference between the two sets of regulations can be attributed to the details provided by OMFP 1802/2014 regarding the types of provisions that may be created and their description. With regard to their increase, IAS 37 provides that provisions are measured before taxation because its effects are regulated by IAS 12. In Romania,

the taxation part is not reflected in the OMFP 1802/2014, but in the Fiscal Code (Law no 227/2015).

As far as the **financial assets** are concerned, they are not found in OMFP 1802/2014 under this name. According to paragraphs 11 and AG3-AG4 of IAS 32, a financial asset is any asset that is cash; an equity instrument of another entity; a contractual right (to receive cash or another financial asset from another entity, or to change financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity); a contract that will or may be settled in the entity's own equity instruments.

In this case, in order to determine the characteristics for the financial assets category, we considered the elements: accounts receivables, green certificates (environment certificates), cash, short-term investments stipulated in OMFP 1802/2014 and we compared the requirements with those included in IAS 32 „Financial Instruments: Presentation” and those presented in IFRS

9 „Financial Instruments”. Thus, in international standards, regarding recognition, financial assets are measured at fair value or at cost, directly attributable to the transaction. Subsequently, they can be measured, based on the entity's business model, at amortized cost, fair value through profit or loss or fair value through other comprehensive income, which differentiates national accounting from international accounting. Upon their entry, according to OMFP 1802/2014, the financial assets are valued at the acquisition cost or the value stipulated in the contracts, and their value at inventory and their presentation in the balance sheet are subject to impairment loss.

Considering that prudence manifests by provisioning, but also in order to determine the degree of depreciation due to permanent physical usage or to determine the size of adjustments corresponding to reversible impairments, for the analyzed categories, we shall present a separate section with the Jaccard coefficients for depreciation and impairment adjustments (**Table no. 3**).

Table no. 3. Formal accounting convergence – amortization and impairment loss

Analyzed element / Details	OMFP 1802/2014	IAS / IFRS
Amortization of intangible assets		
Amortized value	0	1
Useful life	0	1
Methods of amortization	1	0
Changing amortization methods	0	1
Bookkeeping	1	0
Treatment of amortization at retirements and disposals	1	1
Depreciation of Property, Plant and Equipment		
Depreciable cost	0	1
Useful life	0	1
Methods of depreciation	1	0
Changing depreciation methods	0	1
Bookkeeping	1	0
Treatment of depreciation at retirements and disposals	1	1
Impairment of assets		
Identifying an asset that is impaired	0	1
Moment for determining an impairment loss	0	1
Reversing an impairment loss	0	1

Source: Authors' compilation

The values of the Jaccard coefficients for amortization/depreciation and impairment loss, for the

categories in which differences were observed, can be found in **Table no. 4**.

Table no. 4. Jaccard coefficients for amortization and impairment loss

Category	Jaccard coefficients OMFP 1802 – IAS / IFRS	
	Sij	Dij
Amortization of intangible assets	0,17	0,83
Depreciation of Property, Plant and Equipment	0,17	0,83
Impairment loss for assets	0	1
Impairment loss for financial assets	0	1

Source: Author's compilation

The first case, analyzed in a detailed manner, concerns the **depreciation of Property, Plant and Equipment and the amortization of intangible assets** and we observe, in Table no. 4, that the degree of convergence between the two analyzed sets is low (17%). In Table no. 3 it can be seen that the differences refer to the amortized value, the methods of determining the useful life, the allowed depreciation and amortization methods, the regulation for their change and the rules that apply to bookkeeping of the *Property, Plant and Equipment and of the intangible assets*.

First, unlike OMFP 1802/2014, IAS 16 „Property, Plant and Equipment” requires the residual value be taken into account for the calculation of the depreciation, within OMFP 1802/2014 the residual value being null. IAS 16 requires depreciation to be calculated using the method that best reflects the rate at which the economic benefits of the asset are being consumed, while OMFP 1802/2014 presents four accepted methods (linear, degressive, accelerated and calculated per unit of product or service), of which the accelerated depreciation method is not permitted by IAS 16. Under international regulations, companies have to analyze whether the useful life, the rate at which the economic benefits of the asset are being consumed and residual values are in line with economic reality. Otherwise, a reassessment of them is carried out. In OMFP 1802/2014, however, it is considered that the reassessment of the useful life may occur extremely rare, and the change in the depreciation method can only occur when it is determined by an error in estimating the mode of consumption of the benefits associated with that asset. In accordance with IAS 16, depreciation begins from the date of putting into service of the asset, while the OMFP provides that the depreciation is recorded from the first of the month following the entrance of the asset in the entity.

Regarding the amortization of intangible assets, IAS 38 „Intangible assets” specifies two cases: intangible assets that are not amortized, but tested for impairment at least once during the year (for assets with indefinite life) and intangible assets which amortize (for those with defined life).

The second case, analyzed in a detailed manner, concerns the impairment loss that affects *Property, Plant and Equipment and intangible assets*. In Table no. 4 we observe that the degree of convergence is 0, which means that no significant similarities between national accounting regulations and IAS / IFRS have been identified. First of all, even though many notions regarding the depreciation provided by IAS 36 „Impairment of Assets” have been taken over in OMFP 1802/2014, the notion of recoverable amount (with all that it implies for its calculation) and the specifications related to cash-generating units (CGUs) are not presented in the Romanian regulations.

Under IAS 36, an asset is depreciated when its carrying amount is greater than recoverable amount. In this respect, IAS 36 states that recoverable amount is the maximum of the fair value less estimated expense with the sale of the asset and its useful value (the present value of future cash flows arising from the continuing use and disposal of the asset).

OMFP 1802/2014 requires that the valuation of *Property, Plant and Equipment and intangible assets* for the purposes of determining impairment loss shall be made at the inventory and shall be made at the inventory value (determined by the inventory commission or the authorized valuers). The correction of the value is made, depending on the type of depreciation, either by recognizing additional amortization if irreversible depreciation is found or by impairment loss, if there is a reversible depreciation. IAS 36 also requires that, at the

end of each reporting period, an entity should measure the existence of indications that would justify reducing or canceling an impairment loss recognized in prior periods for an asset other than goodwill. If there are any indications in this respect, the entity must estimate the recoverable amount of the asset.

As for the financial assets impairment, IFRS 9 introduces a new model based on expected losses that require early recognition of losses that are expected to arise from impairment of accounts receivables. The Standard requires entities to recognize the expected impairment losses on the accounts receivables from the initial recognition of financial instruments and to recognize the expected impairment losses over the life of the financial instruments.

There is a three-step approach, which is based on the change in the quality of the financial asset from the initial recognition. Doba (2018) explains that, in practice, these new requirements mean that entities will have to record an estimated loss related to a period of 12 months from the initial recognition of the financial assets that are not impaired (or a loss over the expected lifetime for trade receivables).

A final difference globally observed concerns presentation and disclosure. IFRS has in each case a detailed list of information to be included in the financial statements in order to provide a complete, transparent and fair view about the entity's financial position and

performance. These lists are not explicitly found in OMFP 1802/2014, for any of the analyzed items.

4. Conclusions

The undertaken analysis aims to highlight accounting practices that regard the perception of prudence at a theoretical level so that, in future research, we would be able to analyze the convergence through a material analysis (*de facto*). Regarding the results of the formal convergence analysis (*de jure*), Jaccard's coefficients revealed that the highest degree of convergence is recorded for the provisions. On the opposite side, the lowest degree is recorded for financial assets (cash, accounts receivables, temporary investments etc.). Also, accounting treatments for depreciation and impairment of assets, presented in OMFP 1802/2014, significantly differ from those presented in IFRSs. Establishing the extent to which Romanian accounting regulations are converging with International Financial Reporting Standards is a necessary pre-requisite for the purpose of conducting a material convergence analysis (*de facto*), which is why we can emphasize the relevance of this type of study.

The limits of the study refer to the fact that the analysis of the degree of convergence only focused on the issue of prudence, leaving aside the other requirements contained in the two sets of regulations under consideration.

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