

SUBSTANCE OVER FORM IN A ROMANIAN BOOK-TAX APPROACH

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Abstract

The relationship between accounting and taxation in has experienced a rapid and dramatic evolution since 1990. In 20 years, Romania passed through evolutions that required several decades in developed countries. In a very partial analysis of this development we choose to identify tax effects of accounting rule of substance over form. The starting point of our research is the Romanian accounting standards, which list some implications of the substance over form rule. We note that, as expected, the tax rule does not overlap exactly on the accounting rule. In this context, we insist on some cases: lease-back agreements, the recognition of sales of goods. In these developments, we should note that, sometimes, there are different fiscal and accounting solutions, sometimes solutions are identical.

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1. INTRODUCTION

In Romania of 1990s, soon after the starting of modernizing process of Romanian accountancy, the accounting principles, referred to in specific norms, were the ones taken over from European directives, on the well-known French connection. So it is that the substance over form not being a principle suggested by European directives does not explicitly appear in the initial Romanian accounting standards. However, we find references to this principle in the accounting works of some authors describing also something else than French or Belgian accounting: for example, Feleagă and Ionaşcu [1993], Pop [1996]. The initial limited debates reserved to this principle are justified probably by its Anglo-Saxon origin – an accounting system which philosophy significantly differs, in certain respects, from the Continental-European one from which the Romanian standard setter was inspired.

On the other hand, the Romanian tax rules in force after 1990 were also inspired from continental models. At the same time, we notice a very close initial relation between accounting and taxation, taking into account the fact that, before 1990, the company tax system was not so present in a significant way.

The accounting normalization in Romania continued on the initial line but, at the end of 1990s, in Romanian debates, international norms issued by IASC were taken into account. In this way, a daring and somewhat peculiar regulation appears by trying to accomplish a hybrid to harmonize, in the same standard, the specific European directive and

international accounting standards (IASs). We are talking about the Order of the Finance Minister no. 403/1999 for approving the accounting regulation harmonized with the 4th directive of European economic communities and with the IASs (Official Gazette no. 480/1999). The effective application of these norms were carried out after replacing the initial order with another one (OMFP 94/2001) and after setting of entity list that had the obligation to apply these norms.

We made reference to these norms because OMF 403/1999 replaced by OMFP 94/2001 for the first time introduced the substance over form within the list of compulsory accounting principles for some Romanian companies.

At a first glance, this principle can not be fiscally recognized because the tax regulations gave priority to the judicial principle – the supporting documents are very important from a fiscal point of view. However, on a certain section, the fiscal regulation in its turn developed in a way somewhat close to the accounting substance over form. In this respect, since 1994, the ordinance no. 70 regarding taxes on profit (Official Gazette 246/1994), at article 23, specifies that, in the case of transactions between tax payers or between them and a related party or an entity without legal personality which is involved in any way to the management, control or capital of another tax payer or other entity, the value which should be recognized by the tax authority is the market value of the transactions... In this case it is a kind of prevalence of the market price over the price and over other clauses of legal documents: we can consider it a fiscal substance over form. The fiscal norms after 1994 develop this type of prevalence reaching to the adoption and adaptation of a real fighting mechanism against transfer prices. This fiscal approach is not genuine at all – Romania is trying to take over fighting techniques against tax evasion applied in the developed countries. Thus, Levey et al. (2006) show that such arguments are appealed to also by American tax authorities and Williams et al. (2008) confirm the importance of the substance over form principle in the case of relations between affiliated persons. In this respect, we may find even the opinion according to which the substance over form generally follows the same line of the basic requirements of tax law, although they are not totally overlapped (Schön, 2004). An interesting situation offers us the rapid evolution of the Italian fiscal regulations: Gavana et al. (2010) show us that, soon after the compulsory implementation of IAS/IFRS, in 2005, the substance over form principle was not accepted from a fiscal point of view. However, starting with 2008, the Italian fiscal authority has changed the approach, accepting some provisions of IAS/IFRS, including the substance over form principle.

Besides, in this respect, we may mention again Lassègue (1994) who finds a close relation between the accounting substance over form principle and the tax law realism: the tax is levied considering the in fact situations and not necessarily the legal appearances.

In a more recent addition (OUG 58/2010), the Romanian fiscal norms borrow in a way from the spirit of accounting prevalence of the economic principle over the judicial one. In this way, it is specified that in setting an amount for a tax or duty the fiscal authorities readmit the form of a transaction in order to reflect its economic content.

In the following, after a description of defining and developing the substance over form principle in Romanian accountancy (section 1), we shall briefly approach the Romanian relation between accounting and taxation (section 2), after that we shall develop the accounting and tax implications of the concrete application of prevalence in two situations retrieved in the accounting standards: lease-back contract and accounting framing of sale of goods (section 3).

2. ON THE PLACE OF SUBSTANCE OVER FORM IN ROMANIAN ACCOUNTING

The Romanian accounting literature after 1990, the issues regarding the accounting principles are treated, in a large extent, by taking over and developing the principles explicitly provided by the accounting standards and/or by the French inspired sources. We listed above some authors who, before 1999, also refer to the substance over form; a principle about which they say is of Anglo-Saxon inspiration. We notice that this principle is only recalled without special developments, considering that it is not explicitly applied in Romania. The debate is slightly similar to the one mentioned in the accounting French works where sometimes it is also listed this principle but with the mention that it is not applied in the individual unconsolidated financial statements [Caspar and Enselme, 1994].

2.1. Evolution of the official definition of substance over form in Romanian accounting regulation until 2009

We noticed that OMF 403/1999 brings for the first time the obligation to apply the substance over form principle. However, the application of this order was carried out on a limit sample of companies (it started with a series of 13 pilot-economic agents), following that their number to gradually increase until 2005. The initial definition of the principles in question is limited to the mention that “the information presented in the financial statements should reflect the economic reality of events and transactions, rather than their legal form”. In volume 2 of the same document it is also reproduced the General Framework for the Preparation and Presentation Financial Statements issued by IASC, where we can find the qualitative characteristics, among which also the credibility, with its substance over form, defined and explained in detail, presenting even an example.

The replacement of OMF 403/1999 with OMFP 94/2001 significantly enlarged the range of companies applying these regulations, but brings nothing new regarding the definition of substance over form principle, neither to the list of accounting principles applicable by the involved companies or to the translation of the General Framework.

At the same time with the application of OMFP 94/2001, the companies not integrated into this program were applying the usual norms: Government Decision no. 704/1993 for approving the application regulation of the accountancy law and, beginning with 1.01.2003, OMFP 306/2002 for approving simplified accounting Regulations, harmonized with European directives. In the latter normative documents, no reference is made to the substance over form principles, the list being limited to those six principles valid since 1994: conservatism, comparability, going concern, accrual basis, intangibility of the opening balance sheet and non-offsetting, to whom it is also added (by OMFP 306/2002) the separate estimation of asset and liability elements.

This situation in which various companies applied various standards was maintained until 2006, when OMFP 1752/2005 for approving the accounting regulations in compliance with the European directives came into force. Through this standard, the accounting norms applicable for individual companies are unified. In the list of principles offered by this norm, we also find the substance over form. However, the application of this principle is not generalized. It is valid for all entities only in the consolidated financial statements, while, in individual accounting, it is used only by companies which surpass the size criteria related to the sales (7.300.00 euro), the balance sheet total (3.650.000 euro) or the average number of

employees (50). The principle definition is the same like in the preceding norms with the major difference that, in OMFP 1752/2005, *The General Framework...* is not present anymore which was taken over by OMFP 94/2001.

In the absence of a detailed explanation of the way of applying substance over form principle, we can imagine that the companies subjected to the obligation of observing this principle encountered some difficulties in identifying the concrete situations in which the principle can be invoked. In this context, the accounting works must not be ignored in which examples of prevalence are found and, also, the experiences of those who encountered this principle in another context – we are talking about consultants, accountants, auditors that already worked with standards containing such a regulation. Without sliding to the rather political-lucrative side of the issue, we notice that this principle that came together with international norms created a certain market for consultancy, accountancy and audit service providers with multinational presence and with long Anglo-Saxon experiences...

2.2. The current regulation of the substance over form principle in Romania

In order to obtain and present individual financial statements, the entities running activities in Romania are obliged to apply, beginning with the 2010 financial year, OMFP 3055/2009. Even though this order adopts provisions in compliance with the European directives, we should not consider in any way that it is identical with the invoked European directives. A remark of quantitative order can bring light to this issue: 4th directive [DIRECTIVE] has about 18.000 words (in an updated and unofficial version, made available by EU), while the part of OMFP 3055/2009 which translates it has about 44.000 words (without including the chart of accounts, operating account regulations, detailed formats of financial statements). We may find in this order many details, examples, developments in addition to the directives. A large part of these additional elements are coming from IAS/IFRS that became in this way an unavoidable reference in Romanian accounting system. The principle we are concerned with in this text represents one of the items which OMFP 3055/2009 added to the directive: it is not found in the list of those six general principles mentioned in the directive.

Regarding the effective presentation of the principle in OMFP 3055/2009, we find out differences of important details, both quantitatively and qualitatively, which we may consider an evolution compared to the old norms:

- The allotted space is larger;
- Its application is generalized to all categories of entities, without taking into account the dimensions or other particular aspects of the entities;
- A justification of imposing this principles appears: accounting records and accurate presentation of economical-financial operations in compliance with the economic reality;
- It is set a kind of basic rule which creates a good connection with practice: the supporting documents reflect, in a normal way, the manner in which the transactions and events occur, being in compliance with the economic reality; the prevalence means that the economic background of the transaction does not correspond with the judicial form resulted from documents;
- It is mentioned that the situations in which non-compliances occur between the economic background of the transaction and the judicial form resulted from documents should be extremely rare;

- Concrete examples are mentioned of situations where the legal form can differ from the economic background.

From the point of view of the definition given by IASB, we notice a certain evolution within the common project with FASB of modification of the conceptual framework. Thus, the substance over form would become a component of the faithful representation, the latter being one of the fundamental qualitative characteristics of the financial information [Exposure draft..., 2008]. In this way, the prevalence does not explicitly appear in listing the qualitative characteristics and neither to the fundamental ones (relevance and faithful representation), nor to the auxiliary ones (comparability, verifiability, timeliness, understandability). In defining faithful representation, the project of conceptual framework specifies that the financial information that faithfully represents an economic phenomenon depicts the economic substance of the underlying transaction, event or circumstances, which is not always the same as its legal form [ED Frame...].

3. BRIEF CHARACTERIZATION OF THE CURRENT RELATION BETWEEN ACCOUNTING AND TAXATION IN ROMANIA

We stated above that, soon after 1990, the relation between company accountancy and taxation was a close one, a connecting one. In fact, from Law no. 12/1991 regarding the tax on profit, we conclude that this connection was characterized by the acceptance of the taxation of most accounting rules. In terms set out by Lamb et al. (1998), this situation allows framing of most aspects of the accounting-tax relationship in case 3 – accounting leads. This situation is easy to explain – Romania was coming out from a centralized economy where the norms were generally unique without many nuances. At the same time, the standard setter in elaborating accounting and tax rules was the same: the ministry of finance. From this simple initial situation, the evolution was spectacular until nowadays when the debate on the relation between accounting and tax should be discussed taking into account the many variables: the dimensions of the company, quotation or non-quotation at the stock exchange, shareholders clustering, and presence of some foreign shareholders/associates. For example, regarding the companies quoted at the Bucharest Stock Exchange, Fekete et al. (2009) finds out a decreasing tendency regarding tax influence over accounting in Romania, explained by aligning the Romanian accountancy to European and international standards. In our opinion, the tax-accounting relation should not be explained only by the accounting regulations aligning or not to the fiscal regulations and vice versa, but it must be considered also the behavior more or less opportune of the accountants. It is supposed that a small size company should not assume the cost of keeping two records – accounting and fiscal – even though the specific norms allow this case. In this way, we reach to a true connection of accounting with taxation, without being explicitly imposed by a regulation. Examples in this respect we may mention: amortization of non-current assets (useful life and methods), treatment of provisions and adjustments for depreciation, re-estimation of immobilizations, treatment of subsequent costs, classification of some assets as current/non-current... In all stages and in any case, the accountancy is still a basic source for information used both for the needs of financial reports and for the tax purposes (see also Ristea, 2008).

4. TAX IMPLICATIONS AND INTERPRETATIONS OF THE SUBSTANCE OVER FORM PRINCIPLE

In OMFP 3055/2009 we can find a list of situations which the Romanian regulator recognizes as being able to generate differences between the legal form of the transaction and its economic background. We take it over as such:

- Framing, by the users, of leasing contract in operational or finance lease;
- Accounting framing of the selling operations and spreading out/non-spreading out of related income/expenses;
- Participations classification as current/non-current assets;
- Acknowledgement of held participations considered as shares held at affiliated entities, participation interests or in form of other financial immobilizations;
- Classification as financial or commercial deductions given/received at the time of selling/buying or later.

This list copied from OMFP 3055/2009 is an informative one to which we may add also other cases, some of them explicitly recognized by the accounting norm. For example, the account consolidation is based on the fact that the group is viewed as a unique entity, setting aside the legal personality of its components. In the same way, we may develop also the issue of goods and/or services exchange for which OMFP 3055/2009 sets, for the first time in Romania, simple regulations of accounting acknowledging not allowing always the accurate translation of the economic background of the transactions. From the five examples above mentioned, we shall approach further on the first two: leasing operations and accounting recognition of the sales.

4.1. Leasing – a favourite example of substance over form

In many cases, including the Romanian accounting norm, when the identification of a common example of substance over form is taking into account, the leasing operations are invoked [Feleagă and Ionaşcu, 1998; Esnault and Hoarau, 1994; Raffournier, 1996; Feleagă and Feleagă, 2007]. In sustaining this statement, the treatment of financial leasing contracts is considered: the good that is the object of such a contract appears in the user's books and not in the lessor's financial statements (who remained the right owner). However, in the specific situation of Romania, the separation between the financial and operational leasing is imposed by the law. In this way, beginning with 1999, the ordinance no. 51/1997 regarding the leasing operations and leasing companies separates the two types of contracts, separation explicitly took over also in the accounting and fiscal regulations. In these conditions, invoking the separation of the two types of contracts as an effect of substance over form is not a current matter, unless we limit to the general principles of the propriety right...

However, we can find a leasing type contract whose accounting (explicitly specified in the accounting norm) is distancing from what is mentioned in the supporting documents, allowing us to notice the presence of the substance over form principle. We are talking about the lease-back contracts materialized in financial leasing. Such contracts are characterized by the fact that, regarding the leasing transaction its starts, the user is also the supplier. From a legal point of view, the operations we are concerned with related to a financial lease-back are the following: the selling by the user of the asset to the lessor, reception by the user of the asset in financial leasing, invoicing and installment payment, amortization of the asset during the remaining useful life, possible repurchase of the asset at the term of the lease. In

the Fiscal Code, no explicit specification appears regarding lease-back, allowing us to presume that tax obligations are set based on legal documents, e.g. the tax regulation overlaps the legal regulation. From an accounting point of view, until the issuance of OMFP 2374/2007, the standard did not provide anything explicit about lease-back. In such conditions, we may presume that the Romanian companies involved in such transactions were recording each document issued according to the general rules, fact that did not create differences between the accounting recognition and the tax treatment. In the doctrine, on the French model, the lease-back contracts are framed at creative accounting techniques (Malciu, 1999). Beginning with 2008, the accounting standard is changed, specifying that such a transaction does not imply the recording of the input/output of the asset and recognize the economic background just as a financing transaction by the user-supplier from the leasing company. In table 1, we listed in parallel the accounting system and fiscal system specific to the lease-back operations.

Table no. 1 Parallel between accounting and tax treatment in case of financial lease-back, regarding the lessee

Operation	Official accounting approach	Tax/legal solution	Differences
Good sale - invoice	Not recognized because there are not transferred to the lessor all the risks and rewards incidental to ownership	It appears an income equal to the negotiated price with lessor; it is emphasized also the collected VAT if it is the case	The income is taxable, even if it has no immediate equivalent in accounting records
Derecognition of the assets "sold"	It is not the case, the accounts related to the asset do not suffer any modification	The net book value of the asset is recognized on fiscal expenses	The fiscal expenses related to the fiscal income are deductible without having an equivalent in accounting records
Recognition of the asset received in finance lease	No asset account is involved, limiting us in recognizing the input of some money and the appearance of a long term debt	There is not immediate implications, but the asset is fiscally depreciated over at the negotiated value of the contract and not at the net accounting value	The net book value (the same as before the contract) becomes different compared to the tax value (negotiated value) – different records should be kept
Invoice for installments	The accounting record is the usual one, with recognizing of an interest expense	The interest is a deductible expense	There are no differences
Amortization on remaining useful life	The accounting amortization is the same like the one before the contract because nothing has changed in this respect	The fiscal amortization is set based on the fiscal value, that is based on the negotiated value of the contract	In case the contract value differs from the net value before the contract, then the fiscal amortization is different from the accounting one

Operation	Official accounting approach	Tax/legal solution	Differences
Possible repurchase of the asset by the end of a lease term	The long term debts account is closed without consequences on the value of the asset	The user becomes again the owner of the goods with the fiscal value of the contract being amortized	The book value remains different compared to the fiscal one which makes that the accounting amortization to be further on other than the fiscal one

We notice that the accounting approach, in which the economic background of the transaction prevails on the legal appearance, leads to significant differences compared to the fiscal calculations regarding the income tax. This situation is somewhat atypical for Romanian accountancy about which it was said that is rather connected to taxation. We believe that these solutions for treating the lease-back operations are framed in what Lamb et al. (1998) name case 1 in measuring linkage between tax and financial reporting: independence or disconnection, characterized by the fact that the different tax and financial reporting rules are followed for their different purposes. It remains to be seen in what extent the Romanian practitioners should have the courage to pass over the supporting documents and to really apply the substance over form principle... Without having any empirical confirmation, we dare to advance the hypothesis according to which the large companies should apply without too many inconveniences the accounting regulation of prevalence, regarding the small size companies the things should change more slowly. About these latter entities, we may presume that it should be avoided, as much as possible, the creation of differences between the accounting and fiscal treatment, just not to support the additional costs necessary for keeping two sets of different records.

4.2. Sales recognition

In the current Romanian accounting standard, the rules regarding recognition of income and expenses related to goods sales begin by stating that the income from sales of goods are registered at the time of goods reception by the buyers, of their delivery based on invoices or in other conditions provided by the contract attesting the ownership transfer. If we limit to these specifications, then the recognition of this revenue makes the legal event to be decisive for the accounting recognition and not to invoke the substance over form principle.

However, the accounting norm does not stop here. There are set detailed conditions of recognition of revenues from sales, conditions directly taken over from IAS 18 *Income* [Regulations of the Commission no. 1126/2008]. These conditions create premises for, in recognizing the income from sales of goods, the appearance of differences between the judicial form and the economic background of the transaction. The respective conditions are systemized as follows:

- The entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
- The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;

- The amount of revenue can be measured reliably; The income but also the costs of the transaction can be credibly estimated;
- It is probable that the economic benefits associated with the transaction will flow to the entity;
- The costs incurred or to be incurred in respect of the transaction can be measured reliably.

We may wonder how can be recognize, for example, a sale transaction with installment payment, in which the ownership transfer is conditioned on the payment of all the installments. From a legal point of view, the ownership right is transferred after the goods disposal to the customer. That means that, if we apply only the first regulation stated by the Romanian norm, we should wait the collection of all installments in order to recognize the income or rather the income should space out during the collection of the installments. Here, the substance over form intervenes and, if we estimate that the conditions of income recognition are met, we are accounting the total income at the delivery date, even though the propriety right was not transferred. We notice here also an important fiscal consequence: in case the invoice for the entire sale's value is made at the beginning, then the tax revenue is recognized at the same time with the accounting revenue, the two sets of records are overlapped. On the contrary, if the seller estimates that not even one condition necessary to income recognition is met then, from an accounting point of view, we shall face a delay in its recognition, possibly by its spacing out. Obviously, the same treatment is reserved also for the related expenses. In this case, the accounting rule does not coincide anymore with the tax one: the fiscal income is recognized at delivery in case it appears integrally on the invoice, together with the expenses of management discharge – fiscal record source different from the accounting record. Here, also, we may assume that certain companies (mainly the small size ones) would not support the costs of the two separated records, so that they would choose connection of accountancy to fiscality.

Considering the inherent risks of an accounting not taking into account the supporting documents, invoking and application of the substance over form principle may lead to conflicts with other accounting principles such as, for example, the accrual basis (Chen, 2009). The sorting out or the attenuation of these conflicts belongs to the professional reasoning of the accountant called for sorting out the problem.

5. CONCLUSIONS

The modernization of the Romanian accounting also meant the adoption of some Anglo-Saxon accounting regulations, of some principles distancing from traditional approach regarding accounting recognition of some transactions. Since 1999-2000, in the Romanian regulatory system we can also found the substance over form principle. At the beginning, the statement of this principle was made in a concise manner, copying at the same time the formulation of the General Framework of Preparation and Presentation of the Financial Statements issued by IASC. In the absence of some explicit empirical research, it is hard to estimate in what extent this principle found its place in the accounting practice in Romania. We merely assume that the large companies, the ones quoted at the stock exchange and/or the ones with foreign shareholders (and, generally, the companies subjected to an audit), reacted quicker in the way of effective use of this principle. On the contrary, we believe that in small size companies the accountants prefer to take into account the legal appearance, mainly when it provides also the compliance with tax obligations. Beginning with 2010, the

Romanian accounting norm (OMFP 3055/2009) brings important changes regarding the content of substance over form, creating a frame in which the application of this regulation to be able to become compulsory in situations explicitly specified in the norm. Of the five examples specified in the norm, we selected two – lease-back and accounting recognition of some sales – concluding that the prevalence application leads to significant differences between the accounting information and the tax treatment based on the supporting documents. In this way, in case of financial lease-back contracts, the accounting treatment obliges to account only for the financial operation, evidencing the debt and the cash entered, without modifying the elements regarding its asset and amortization. On the contrary, fiscally, the transaction is treated as a sale, evidencing the taxable income and related deductible expenses. At the same time, (re)taking over of the goods is carried out at the negotiated value of the contract and, to the extent in which it is different from the net book value before the transaction, the fiscal value (the tax base) is other than the book value. One of the immediate consequences is the difference between the accounting amortization and the fiscal one of the asset that is the object of the financial lease-back transaction. According to the schedule proposed by Lamb et al. (1998), we framed this situation at case 1 of linkage between tax and financial reporting: disconnection. In case of sales of goods, the Romanian rule is taking over the income recognition conditions set by IAS 18, leading to situations in which the legal appearance (documents) does not correspond to the economic substance. The found out example is the installment sale conditioned by the payment of all installments. From a fiscal point of view, if there is only one invoice, the income and the related expenses are recognized at the starting time. However, from the accounting point of view, it is necessary to estimate in what extent the economic substance of the transaction is telling us that entity has transferred to the buyer the significant risks and rewards of ownership of the goods. If this transfer is considered as accomplished, then the legal and fiscal appearance is confirmed by the economic substance of the transaction. On the contrary, if it is hard to sustain that the transfer of risks and benefits was accomplished, and then the tax and the accounting rules lead to different resolutions of the matter.

The main limitation of this paper is the lack of empirical evidence about the relationship between accounting and taxation, in the area of leasing operations and recognition of sales. In the same time, it will be extremely interesting to extend the area of our research to other former communist countries with a similar evolution after 1990. We intend to do such researches in a future paper.

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