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Explaining Accounting Policy Choices of SME's: An Empirical Research on the Evaluation Methods

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Abstract:

Analyzing accounting issues relative to small and medium sized entities (SMEs) we found the influence of taxation as the main leitmotif in the Romanian literature. However, weak empirical evidence is provided to sustain this argument.

In this paper we investigate the accounting policy choices of SMEs, particularly those related to the evaluation methods. Our purpose is to find some "pattern" in these decisions and to identify the main factors that trigger them. Data for the study was collected through a survey in which respondents were requested to indicate the degree to which each of the factors listed in the questionnaire influenced their choice of accounting methods. After controlling for size, we applied the principal component analysis technique in ascertaining the impact of factors.

Our results though consistent with the reviewed literature, are still surprising. This is in the sense that while taxation seems to remain the strongest influence factor, the weakest happens to be the true and fair view (TFV) consideration. In finding some possible explanations to this, we leave this question open: is it possible that the overwhelming academic concept of TFV is an empty vessel for practitioners?

JEL Classifications: G19

Keywords: Accounting standards, financial accounting, SME's.

1. Introduction

According to financial accounting theory companies choose their accounting (including evaluation) methods in order to provide a true and fair view on their activities. These choices are captured in the accounting policies of the entities and are the foundation of drawing up and interpreting their financial statements, i.e. financial position, performance and cash-flows of the period. Therefore companies

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make deliberated choices on alternative accounting methods, often labeled in the literature as “professional judgment”.

On the other hand, according to the Romanian literature (Berinde, 2004; Berinde and Răchișan, 2005), entities – particularly SMEs – are strongly interested in tax optimization, which lead to a significant influence of taxation over accounting. Although many authors discussed this issue, each of them building upon his/her practical experience, there is no prior empirical research, that could (have) confirmed (ed) this impact.

In this paper we investigate the accounting policy choices of SMEs, particularly those related to the evaluation (measurement) methods. Our purpose is to find some “pattern” in these decisions and to identify the main factors that trigger them. The most important contribution of this research is that it is a pioneering work in the policy choices of Romanian companies since there is no prior empirical study in this field. Our results though partially consistent with the reviewed literature, are still surprising. This is in the sense that while the factor called “taxation” turned to have the strongest influence, as suggested in the literature, the weakest happens to be the true and fair view (TFV) consideration, which contradicts our expectations. The question then is: how it is possible, that the most fundamental “academic” consideration is the least respected by practice?

The rest of the paper is organized as follows. In the next section we review the relevant international and local literature. Since in Romania there is no prior study on the determinants of accounting policy choices, we extend our inquiry to conceptual and theoretical aspects, which, in turn, has been thoroughly investigated (see for instance Feleagă and Malciu, 2002; Bunea, 2006). In section 3 we present the research design, starting from variable definition and data collection (sampling) to specifying the statistical model and analysis applied. Section 4 is dedicated to discussion of the results while our conclusions are provided in the final section of the paper.

2. Literature review

In the conventional research paradigm, it has always been the premise to design research in the area of accounting policy choice drawing on the conjecture that accounting practices and the application of particular policies by firms in particular environment normally reflects the existing rules and regulations (including but not exclusively accounting standards) obtainable in the environment in which such firms operate. See for instance studies by: Perera, (1989) and Skinner, (1993). Going by this line of argument therefore, it is expected that when designing their accounting policies, their main area of concern is the need to meet statutory requirements regarding the ways and manner in which their financial statements are prepared. This argument appears to have been framed bearing in mind the operations of very large global enterprises that are subjects of close monitoring by the various markets where they are listed as well as the different political environments they face. For example both the UN and OECD do specify guidelines for accounting and disclosure practices by Multinational Companies. These guidelines mainly try to

provide conditions that will ensure transparency and accountability in financial reporting by such multi-national firms especially given their levels of complexities and the extent to which they affect the economies of many countries in the course of their operations. However, while such expectations may be necessary in respect of very large business entities, same can not be said of small scale enterprises (or small and medium sized enterprises, SMEs). Moreover, there are reasons to contest the assumption of the dominance of legal and statutory regulatory conditions in the accounting policy choice of firms. For instance, as observed by McLeay and Jaafar (2007), the selection of particular accounting method by companies is likely to depend to a large extent not only on the firm's location and the set of regulations involved but also on its operating environment and the circumstances it faces in such an environment. In support of this line of argument for instance, Watts and Zimmermann (1990) provided empirical evidence to suggest that variables such as industrial classification, business ownership structure, corporate culture, etc, can all influence the choice of accounting and reporting policies of firms. Similarly one can add to this line of argument that firm size is equally of very high tendency to affect accounting policy choice a situation that appears to have been identified by bodies like the International Federation of Accountants (IFAC) and Accounting Standards setting bodies like Financial Accounting Standards Board (FASB) of the US and the Accounting Standards Board (ASB) of the UK. It is in realization of this condition that these bodies came to recognize the need to have special accounting standards developed for application by SMEs as opposed to having them subjected to the jurisdiction of compliance with highly technical and often complex accounting standards like the International Financial Reporting Standards (IFRSs) which are meant to address issues peculiar to large and diversified corporate bodies. In the literature, it has also been established that greater demand on large firms to supply information to interest groups such as creditors suppliers, analysts and the general public often make them to have higher levels of disclosure compared to smaller entities (Buzby 1975). Also by way of further evidence, Cooke (1989) based on Swedish companies' data and Raffournier (1995) on Swiss listed companies documented the existence of significant association between the size of enterprises and the extent of disclosure. If size plays a significant role in determining the extent of disclosure by companies, it will then mean that SMEs would almost be certain to disclose less information and also to choose their accounting and disclosure policies based on their individual operational capacities and the environmental characteristics they face principal among which are the tax systems, the patterns of demand for company information by market operators such as financial analysts, banks, creditor groups and similar users.

In our study, we hypothesized the possibilities of factors like taxation, the 'true and fair' principle, desired to project positive image within the society and the need to meet professional requirement (e.g. the provision of financial statements in line with standard regulations) as factors with significant influence in determining the accounting policy choice decisions of SMEs in the Romanian corporate setting. With regards to earnings management for instance studies in the literature have

demonstrated the existence of a positive relationship between earnings management considerations and the choice of accounting policies. Based on their study of policy choice with regards to accounting for transition obligation, D'souza *et al.* (2001) argued that firms' choice of accounting method in this respect was most likely to hinge on the intentions of the firms to reduce labor renegotiation costs and by extension improving their future earnings.

In another study (Tzovas, 2006) using data from firm managers in Greece, the author documented evidence of positive association between the extent to which firms aimed at reducing their tax liabilities and the extent to which they wish to report profits with tax reduction effects and the optimism to positively influence bank loan decisions. Similar contributions in this respect can be found in the works of Wolfson (1993) and Cloyd *et al.* (1996).

Bosnyák (2003) studied in Hungary the accounting policy choices of both large corporations and SMEs. His findings confirm the de facto impact of taxation on accounting, since the strongest factor was the "taxation", explaining 26.17% of decisions as presented in table 1 below:

TABLE 1: Factors of policy choices of SMEs in Hungary

Factor	Name	% of variance explained
1	"taxation"	26.174
2	"favorable image"	14.468
3	"information"	9.583
4	"profession"	6.706
5	"recording"	6.147
Total		63.078

Bosnyák (2003), p.117

Feleagă and Ionașcu (1993) is the first book in the Romanian literature dedicated to the conceptual aspects of accounting, including accounting policies. The authors argue for a stronger conceptualization of Romanian regulations. The further edition of their book (Feleagă and Ionașcu, 1998) provides a more in depth analysis of accounting concepts and principles, discussing comparatively the European, international and American approaches. The focus is on macro (standard setting) and not on micro (entity) level, therefore accounting policy choices are discussed in the context of accounting rules.

Later, the results of an outstanding research dedicated to accounting policies was published in Feleagă and Malciu (2002), where the authors analyzed the accounting options (choices) from the perspective of entites, taking in consideration both Romanian and international (European, IASB) frameworks.

Continuing this logic, a more practical approach is found in Duțescu (2003), who proposes a framework for drawing up accounting policies based on the Romanian regulations in force at that time. This was a useful guide for Romanian

companies, since choosing an accounting treatment and bringing arguments for that choice was a real challenge for Romanian professionals.

Bunea (2006) provides an overview and a deep analysis of conceptual issues related to accounting policies, starting from international and national regulation of accounting to the corporate practices. The most important topics discussed refer to the influence of culture, definition and measurement of financial position and performance, conservatism vs. optimism in the design of accounting policies, optimization of financial position and performance of entities.

In Romania, as anywhere in the world, the large majority of entities are SMEs, whose principal financial statements users are the state authorities (Malciu, 1998). By SMEs we mean entities that “do not have public accountability and publish general purpose financial statements for external users. Examples of external users include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies” (IASB, 2007, p.14)². This does not necessarily correspond to the definition of the Romanian standard setter, according to which SMEs include entities that satisfy the following conditions (Law 364/2004, par. 3):

- Average (annual) number of employees less than 250, and
- Annual sales less than 50 million euro, or total assets less than 43 million euro; all figures according to the latest annual financial statements transformed in RON at the official exchange rate.

If the state is the most important user, especially in case of SMEs, it follows that accounting must be influenced by taxation (Berinde and Răchișan, 2005). This particular aspect was largely debated in the Romanian academic and professional forums/conferences, in the literature and also in course books (Matiș, 2005; Matiș and Pop, 2007). For example, Berinde (2004) analyzed the introduction of the concept of deferred (income) tax in the Romanian legislation³ as the early effort towards the separation of accounting from taxation.

Petre and Lazăr (2006) argue that the regulation of accounting is not connected to taxation. In practice the entities might use fiscal instead of accounting rules, but this pertains to practice and not regulation, “there is no subordination of accounting to taxation and accounting rules are not harmonized with fiscal rules.” (Petre and Lazăr 2006, p. 6) They consider that “such opinion that accounting serves fiscal interests represents at least not knowing the current Romanian reality” (Petre and Lazăr 2006, p. 6).

² According to IASB (2007, p. 14) “an entity has public accountability if: (a) it files, or it is in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; or (b) it holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance entity, securities broker/dealer, pension fund, mutual fund or investment banking entity.”

³ Decision of the Ministry of Public Finance no. 9/08.10.2003.

3. Sample and research design

The entities included in the study were selected by stratified sampling, thereby ensuring that the sample fairly represents the population of SMEs in Romania. We sent out copies of our questionnaire to a total of 562 entities, from which we received 51 valid answers, which represent 9.07% of the original sample ($9.07\% = 15.48\% * 56.62\%$), as presented in table 2. This seems statistically acceptable, since similar results were obtained by Bosnyák (2003) in the neighboring Hungary.

TABLE 2: Sample description

	Number of entities
Questionnaire sent out	562
Answers received	87
Response rate (%)	15.48
less:	
- Micro entities	16
- Incomplete answers	20
Valid (complete) answers	51
Valid answers rate (%)	58.62

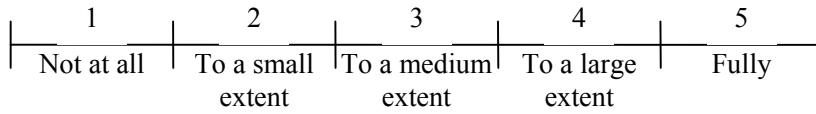
We collected various data from these entities, starting from corporate characteristics (assets, equity, sales, leverage, number of employees, sector of activity etc.) to factors impacting accounting policy choices. Concerning this latter variable, we used the framework proposed by Bosnyák (2003), who identified and used 20 attributes on a representative Hungarian SME sample. These attributes are presented in table 3 and are assumed to influence choices concerning evaluation methods.

Each entity, through its representative (CFO, Chief Accountant etc.) was asked to assess the impact of each attribute in the choice of accounting evaluation methods on a Likert scale from 1 to 5 as explained in figure 1 below. For example, attribute 2 called “Minimization of profit tax” received an average score of 2.90 as the degree of impact it had on the evaluation methods chosen by the specialist in drawing up the accounting policy of the entity (e.g. on depreciation methods, on inventory evaluation method: LIFO, FIFO, WAC; product costing, etc.).

TABLE 3: Questionnaire design and descriptive statistics (N=51)

	Attributes influencing accounting policy choices (with regard to evaluation methods)	Mean	Std.Dev.
1	Minimization of the cost of accounting activities, cost of changes in recording system	2.53	1.172
2	Minimization of profit tax	2.90	1.221
3	Utility of information for shareholders and creditors obtained by certain methods	3.04	1.183
4	Information on the evaluation methods used by competitors or similar profile entities	2.49	1.189
5	Methods of evaluation proposed in scientific works (papers, books, internet)	2.53	1.172
6	Merging accounting records with fiscal records, conformity with evaluation methods for fiscal purposes	3.57	1.100
7	Creation of a favorable image of the entity for potential shareholders	3.02	1.257
8	Creation of a favorable image of the entity for current shareholders	2.63	1.148
9	Specified and specific information needs of managers	3.61	0.981
10	Specified and specific information needs of shareholders	3.65	1.074
11	Minimizing other taxes and contributions (others than profit tax)	2.59	1.314
12	Image of the entity qualified as fair by the auditor	3.16	1.172
13	Tax inspectors to agree with evaluation method chosen	3.41	1.283
14	Conformity of financial statements with the philosophy of true and fair view	3.78	0.945
15	Tradition of accountants, fear from new change to methods	2.33	1.306
16	Maximum use of tax incentives	3.31	1.225
17	Influencing the amount of distributable profit to shareholders and management, respectively	2.53	1.347
18	Minimizing the fiscal charge of taxes and contributions regarding the income of shareholders	2.92	1.262
19	Information disclosed in financial statements brings advantage to the entity in application for grants, subsidies, bids etc.	2.96	1.356
20	Choosing the method that reflects the best the characteristics of the resources of the entity (factors of production)	3.08	1.230

based on the framework proposed by Bosnyák (2003)

FIGURE 1: The measurement scale of influence of attributes

The analysis of data is carried out by the technique of factor analysis (for details on the application of this technique see: Emory, 1985, pp.402-407; Füstös et al. 2004, pp. 249-260; Kovács, 2006, pp. 71-96). Since we were curious about the pattern of influence of previously presented attributes, we applied the principal component analysis (PCA) to identify and extract the factors and the level of influence on the accounting policy choices. Results were generated using SPSS 11.0 computer software.

4. Discussion of results

Standard deviation values of the attributes are not very dispersed, as presented in table 2 $Std.Dev \in [0.945;1.356]$, therefore we expect the data to be appropriate for factor analysis. The appropriateness of data for factor analysis was further tested by the Kaiser-Meyer-Olkin Measure of Sampling Adequacy. The value of KMO is 0.683 which can be considered “weak” according to Füstös *et al.* (2004), however it is statistically significant (sig. = 0.000).

The results of the analysis are presented in the tables below.

The communalities represent the estimates of the variance of each variable (attribute) which is explained by the factors identified and are presented in table 4. We identified 6 factors as discussed below. The initial value of commonalities is 1 because all the variables are standardized; the value after extraction is relatively high, each attribute having strong correlation with at least one factor. Thus, no exclusion of any attribute is performed.

TABLE 4: Communalities

Attributes	Initial	After extraction	Attributes	Initial	After extraction
1	1.000	0.689	11	1.000	0.848
2	1.000	0.885	12	1.000	0.683
3	1.000	0.832	13	1.000	0.741
4	1.000	0.765	14	1.000	0.810
5	1.000	0.559	15	1.000	0.808
6	1.000	0.667	16	1.000	0.719
7	1.000	0.788	17	1.000	0.701
8	1.000	0.762	18	1.000	0.804
9	1.000	0.775	19	1.000	0.772
10	1.000	0.839	20	1.000	0.648

The results of PCA are summarized in table 5. According to this 6 factors ('components' in SPSS) were identified, that cumulatively explain 75.49% of total variance. A factor is selected if the eigenvalue of its covariance matrix is higher than 1, which means that it provides more information than the initial variable (attribute).

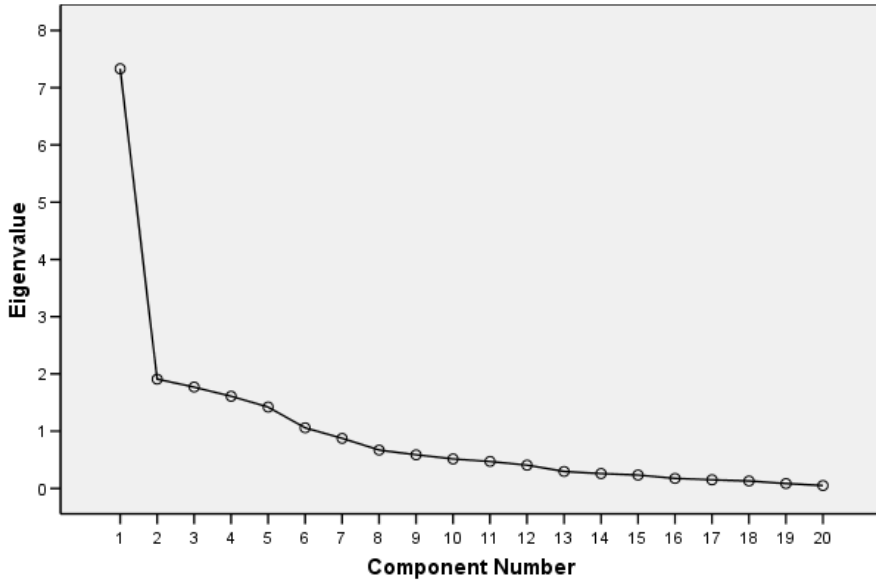
The most important factor explains far the most of the total variance (36.65%), the rest of the factors explaining less than 10%. This is presented graphically on the scree plot on figure 2, where after the first factor there is drop in eigenvalues.

TABLE 5: Components and their explanatory power

Total Variance Explained

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings			Rotation Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	7.331	36.654	36.654	7.331	36.654	36.654	3.372	16.859	16.859
2	1.908	9.542	46.196	1.908	9.542	46.196	3.149	15.747	32.606
3	1.770	8.849	55.045	1.770	8.849	55.045	2.870	14.349	46.955
4	1.609	8.046	63.091	1.609	8.046	63.091	2.858	14.290	61.245
5	1.421	7.104	70.194	1.421	7.104	70.194	1.585	7.926	69.171
6	1.058	5.291	75.486	1.058	5.291	75.486	1.263	6.315	75.486
7	.874	4.372	79.858						
8	.670	3.349	83.207						
9	.587	2.937	86.144						
10	.515	2.575	88.719						
11	.471	2.353	91.072						
12	.406	2.032	93.103						
13	.296	1.480	94.583						
14	.259	1.295	95.878						
15	.234	1.171	97.049						
16	.175	.874	97.923						
17	.151	.755	98.678						
18	.129	.646	99.324						
19	.085	.425	99.749						
20	.050	.251	100.000						

Extraction Method: Principal Component Analysis.

FIGURE 1: Scree plot**TABLE 6: Initial and Rotated Component Matrix**

Panel A. Initial Component Matrix						
	Components					
Attr.	1	2	3	4	5	6
1	0.602	-0.294	-0.046	-0.487	-0.001	0.030
2	0.648	-0.088	-0.612	-0.127	0.044	0.254
3	0.560	0.045	0.073	0.138	-0.676	0.187
4	0.661	0.262	0.174	-0.257	-0.385	-0.124
5	0.532	-0.224	0.356	-0.092	-0.095	-0.285
6	0.744	-0.143	0.148	-0.217	0.150	0.042
7	0.494	0.727	0.098	-0.026	-0.040	0.068
8	0.615	0.382	-0.216	0.364	0.239	-0.034
9	0.624	-0.285	0.507	0.041	0.213	-0.019
10	0.646	-0.296	0.538	0.162	0.124	-0.043
11	0.621	-0.205	-0.426	-0.296	0.058	0.386
12	0.450	0.622	0.191	-0.014	-0.128	0.202
13	0.741	0.229	0.125	-0.307	0.175	0.014
14	0.215	0.057	0.378	0.208	0.483	0.584
15	0.400	0.463	-0.142	-0.229	0.356	-0.484
16	0.538	-0.077	-0.303	0.404	0.370	-0.179

17	0.722	-0.244	-0.135	0.245	-0.028	-0.202
18	0.795	-0.236	-0.200	-0.248	-0.081	-0.092
19	0.624	-0.040	-0.240	0.549	-0.137	-0.055
20	0.598	-0.088	0.033	0.437	-0.300	0.028

Panel B. Rotated Component Matrix						
	Components					
Attr.	1	2	3	4	5	6
1	0.455	0.680	0.072	-0.056	-0.003	-0.107
2	-0.079	0.831	0.124	0.408	0.083	0.009
3	0.207	0.203	0.333	0.141	0.775	-0.131
4	0.407	0.260	0.610	0.006	0.281	-0.285
5	0.702	0.098	0.104	0.088	0.101	-0.168
6	0.583	0.483	0.237	0.156	-0.009	0.116
7	0.030	0.052	0.868	0.154	0.046	0.075
8	0.034	0.138	0.478	0.699	-0.059	0.146
9	0.807	0.120	0.071	0.166	0.037	0.275
10	0.831	0.042	0.063	0.237	0.150	0.253
11	0.055	0.886	0.070	0.169	0.101	0.128
12	0.059	0.044	0.783	0.052	0.192	0.160
13	0.441	0.435	0.568	0.115	-0.126	0.081
14	0.187	0.018	0.139	0.059	-0.026	0.867
15	0.145	0.128	0.543	0.280	-0.568	-0.272
16	0.163	0.198	0.009	0.787	-0.168	0.079
17	0.431	0.308	0.030	0.611	0.172	-0.128
18	0.440	0.673	0.146	0.281	0.102	-0.219
19	0.141	0.145	0.114	0.766	0.362	-0.026
20	0.301	0.084	0.139	0.507	0.523	0.007

The next step is to identify the components of each factor, that is, our original attributes to which factor belong to. To this end, we use the component matrix (table 6, panel A) and after the rotated component matrix (table 6, panel B) to identify these components. Rotation was carried out by Varimax method with Kaiser normalization.

In selecting the components of factors we used the highest score in the rotated matrix as the decision rule; we chose the rotated solution because normally it provides a clearer picture on correlation between factors and attributes making possible more correct interpretation, of course, with the price of altering the initial solution. According to this rule, the attribute belongs to that factor, where it has the highest score; for each attribute this was bolded in the rotated component matrix (table 6, panel B).

The components of the factors therefore are:

Factor 1:

- 5. Methods of evaluation proposed in scientific works (papers, books, and internet)
- 6. Merging accounting records with fiscal records, conformity with evaluation methods for fiscal purposes
- 9. Specified and specific information needs of managers
- 10. Specified and specific information needs of shareholders

Factor 2:

- 1. Minimization of the cost of accounting activities, cost of changes in recording system
- 2. Minimization of profit tax
- 11. Minimizing other taxes and contributions (others than profit tax)
- 18. Minimizing the fiscal charge of taxes and contributions regarding the income of shareholders

Factor 3:

- 4. Information on the evaluation methods used by competitors or similar profile entities
- 7. Creation of a favorable image of the entity for potential shareholders
- 12. Image of the entity qualified as fair by the auditor
- 13. Tax inspectors to agree with evaluation method chosen

Factor 4:

- 8. Creation of a favorable image of the entity for current shareholders
- 16. Maximum use of tax incentives
- 17. Influencing the amount of distributable profit to shareholders and management, respectively
- 19. Information disclosed in financial statements brings advantage to the entity in application for grants, subsidies, bids etc.

Factor 5:

- 3. Utility of information for shareholders and creditors obtained by certain methods
- 15. Tradition of accountants, fear from new change to methods
- 20. Choosing the method that reflects the best the characteristics of the resources of the entity (factors of production)

Factor 6:

- 14. Conformity of financial statements with the philosophy of true and fair view

In principal component analysis interpreting the economic content of factors is the most challenging part of the entire analysis (Kovács, 2006). Therefore we proceed to find the appropriate “name” or “descriptor” for each factor.

Factor 1 was expected to be the taxation dimension, as on Hungarian data, but in our case fiscal influences, although present in this factor, tend to concentrate in factor 2. Factor 1 seems to comprise the need of users, such as managers, owners and the state. Merging accounting and fiscal records seems to “simplify” the problems of accountants in practice. Therefore we termed this factor “information”, meaning the information needs of users.

Factor 2, as already mentioned, can be unambiguously called “taxation”. We find here the collective influence of profit and other taxes and contributions, as well as the minimization of the cost of accounting activities. The fact that minimization of the cost of record keeping strongly correlates with taxation confirms our previous conjecture on “simplification”, sustained also by Petre and Lazăr (2006).

Factor 3 and factor 4 are very similar in that they comprise the influence of several parties’ view on the companies and could be termed as “favorable image” that the accountant creates about the entity. Therefore factor 3 can be considered as “favorable image for third parties” and factor 4 as “favorable image for shareholders”.

Factor 5 we named “economics”, since it characterizes the economic fundamentals of the entity, such as: utility of information for shareholders and characteristics of the resources of the entity. There is also the tradition which pertains to the professional dimension, but since this is negatively and the least strongly correlated, we believe it has the least impact.

The last factor is the “true and fair view consideration” as it has only one component. It is puzzling that this aspect has the smallest impact on accountants. This and other conclusions driven from the above results are explored in the next section.

5. Conclusions

First of all our findings confirm the de facto influence of taxation on accounting/accountants, as suggested in the literature. Although the most relevant factor turned to be the “information need of users”, and only the second one is the “taxation”, we find strong influence of state information need in the first one.

Entities seem to attach particular importance to their external image (owners and other third parties) as captured in factor 3 and 4. This might be explained in terms of prestige but we believe the need for finance to be more relevant (bank loans, grants, subsidies etc.).

Factor 5 expresses the consideration for the economic fundamentals of the company in deciding over evaluation methods in accounting policy decisions. The negative correlation of tradition (-0.568) seem to reinforce this since conservatism in using a particular method seems not to bias decisions.

We are instead puzzled by the fact that the true and fair view consideration is the least important of accountants. This is a major academic accounting concept

that governs the accounting theory. In finding some possible explanations to this, we leave this question open: is it possible that the overwhelming academic concept of TFV is an empty vessel for practitioners?

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