

COMPARISON OF ACCOUNTING METHODS FOR BUSINESS COMBINATIONS

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Received: November 30, 2011

Abstract

SEDLÁČEK, J., KŘÍŽOVÁ, Z., HÝBLOVÁ, E.: *Comparison of accounting methods for business combinations*. Acta univ. agric. et silvic. Mendel. Brun., 2012, LX, No. 2, pp. 315–324

The revised accounting rules applicable to business combinations in force on July 1st 2009, are the result of several years efforts the convergence of U.S. and International Committee of the Financial Accounting Standards. Following the harmonization of global accounting procedures are revised and implemented also Czech accounting regulations. In our research we wanted to see how changes can affect the strategy and timing of business combinations. Comparative analysis is mainly focused on the differences between U.S. and international accounting policies and Czech accounting regulations. Key areas of analysis and synthesis are the identification of business combination, accounting methods for business combinations and goodwill recognition. The result is to assess the impact of the identified differences in the reported financial position and profit or loss of company.

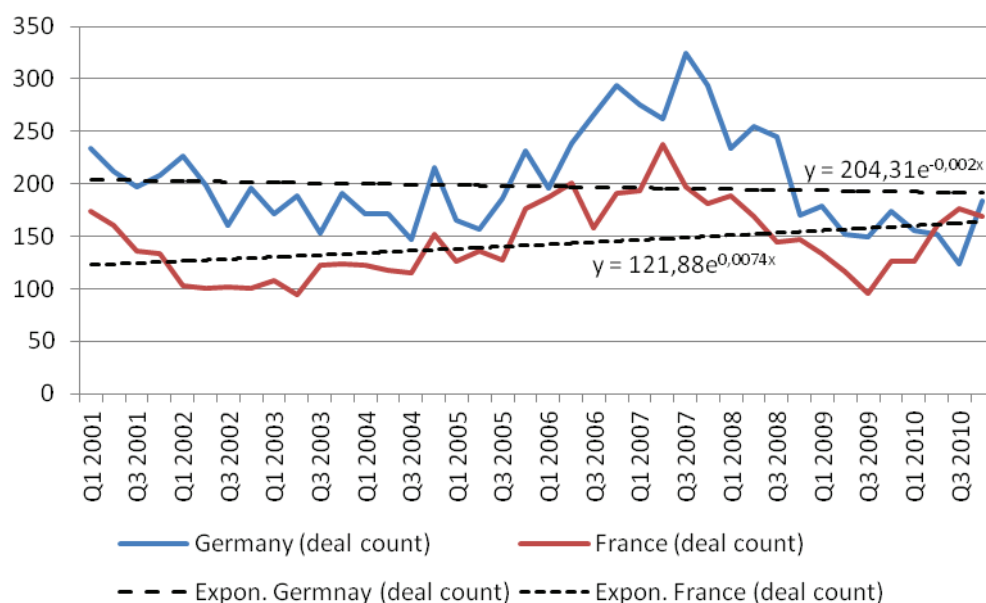
business combinations, types of mergers and acquisitions, mergers and acquisitions development, macroeconomic environment, accounting methods, U.S. GAAP, IFRS, CAR

In the business management theory business combinations are usually related to company growth strategies. They represent an external form of growth during which a combination with another company or other companies takes place and an economically stronger and more efficient unit or group is created. In contrast to an internal (organic) growth of a business, which is often implemented in the form of reinvestments of incomes, building of new plants, implementation of advanced technologies, etc., business combinations are less demanding as concerns the actual process of implementation and the time necessary for a business transformation. The reason for the external form of growth is mainly the assumption (Cassiman and Colombo, 2006) that transformations bring a potential to improve in comparison with the current situation and that the resulting form of the company will have higher production capacities, will be more efficient and will use its advantages at available markets. When enterprises are combined, a concentration of capital occurs accompanied by the creation of a stronger economic group, the ownership structure changes, new organization systems are created and developed as well as various

projects in personnel policy, a global company culture and philosophy is born.

The historic significance of business combinations has gradually grown over borders of individual countries and has become an influential factor of the development of the world economy and financial flows. Cross-border combinations or also global business combinations have led to a creation of multinational corporations which can reach economies of scale more easily and gain a dominant position on markets with services and goods. At the same time, business combinations in this form stimulate direct foreign investments in target countries. If company transformations, in business terminology referred to as mergers and acquisitions (M&A), affect the economy of a country, macroeconomic changes affect business strategies based on the external form of growth, i.e. activities at M&A markets, to the same degree.

The study into the historical development of company combinations, specifically mergers and acquisitions (M&A), has proven that activities in the M&A market did not happen evenly but they fluctuated in dependence on the level of the economic environment, the development of



1: Development of M&A in Germany and France (volume of deals)

Source: Bloomberg (2011) and authors

financial markets and mainly the ideas of bidders and target businesses about the price of a takeover. Some authors in this respect use the term merger and acquisition waves – these waves come at a certain level of development of an economy. E.g. Levy and Sarnat (1994), Bobenic-Hintos (2009), Bruner (2004), Martynova and Rennebook (2008) or Lipton (2006). We may think, together with other authors (Bruner 2004) that at the top of the economic cycle businesses have free cash funds and acquisitions and mergers represent good investment opportunities for them. A transformation can bring a higher economic potential as regards competitiveness than repeated investments in company internal changes, construction of new plants, implementation of new technologies, etc. The growth of world economy promotes efforts towards concentration of capital and application of acquisitions and mergers in a global scale. Looking at the opposite stage of the economic cycle, in the period of economic problems and low capital prices in financial markets activities in the area of mergers and acquisitions should increase, not slow down. The economic motive is probably somehow related to growing markets, when purchase is more intensive. Generally however, no clear and strong correlation between the progress of the economic cycles and activities in the area of mergers and acquisitions has been found (Brealey, Myers, 2000).

The role of business combinations within the growth of corporations and by implication the entire country's economy can be documented by means of activities at the market. Activities are measured by the number of transactions implemented at the M&A market within the monitored period and by their volume. According to the data published by Bloomberg (2011), the M&A market development

trend in Germany and France was estimated (Fig. 1). While the number of transactions implemented in Germany in the past ten years manifests a slightly decreasing regression function, France displays an opposite trend. The highest number of transactions was recorded in the US market, where 1930.2 business combinations on average took place in each quarter of the monitored period.

Markets usually do not distinguish between acquisitions and mergers, which are then considered synonymic. An agreement on a combination of two or more enterprises into one, which thus gains more advantages than if the companies did business separately, is usually referred to as a merger. According to West's Encyclopedia of American Law (2011) is a merger or acquisition a combination of two companies where one corporation is completely absorbed by another corporation. The less important company loses its identity and becomes part of the more important corporation, which retains its identity. A merger extinguishes the merged corporation, and the surviving corporation assumes all the rights, privileges, and liabilities of the merged corporation. A merger is not the same as a consolidation, in which two corporations lose their separate identities and unite to form a completely new corporation.

The Czech trade law defines a merger as a combination in which one or more companies cease to exist without liquidation and their equity, including rights and duties following from labour-law relations, are transferred to another existing or a newly established successor company. It means this is a legal combination which requires an agreement of all participating companies. Similarly, the European law (Directive 2005/56/EC of the European Parliament and of the Council of

26 October 2005 on cross-border mergers of limited liability companies) defines a merger as a process in which one or more companies, on being dissolved without liquidation, transfer all their assets and liabilities to another existing or a new company, in exchange for the issue of securities or shares representing the capital of the successor company and, if applicable, a cash payment not exceeding 10% of the nominal value of those securities or shares.

On the other hand, an acquisition is a transaction in which one company (the bidder) gains a decisive share of the basic equity of another (target) business. The acquisition can have a character of a capital investment (capital acquisition) or a property acquisition, in which the entire company or its part is purchased. By this a group of companies connected by their capital arises and the legal position of individual companies does not change. Unless this is a hostile takeover, also a legal takeover can take place in case of property acquisition or capital acquisition by one owner. The differences between mergers and acquisition will mainly stand out in accounting procedures (Bohušová, Svoboda, 2010).

Accounting and reporting for business combinations has become the centre of our attention because, although theoretically it should not affect decisions about a purchase or a sale of a company, understanding of reporting can facilitate an agreement on the price of the transaction including the decision as to what information will be provided to business owners. The strategy and the timing of M&A will be most affected by the accounting method used for the creation of statements on the financial situation and performance of the company before the business combination, at the time of the combination and finally in the periods after the combination. One of the aims of the study and the subject of this paper is to evaluate the influence of accounting approaches to business combinations on the reported financial situation of participating companies. In order to ascertain the differences in accounting approaches and their economic consequences, an analysis of US, international and Czech accounting standards will be conducted.

1 MATERIALS AND METHODS

The initial information source for our research is the accounting principles for reporting business combinations. Three sets of accounting principles will be analysed and compared. These are represented by three standards and further accounting regulations:

- ASC 805 – *Business Combinations* in the U.S. generally accepted accounting principles (U.S. GAAP)
- IFRS 3R – *Business Combinations* in the International Financial Reporting Standards (IFRS)
- CAS 011 – *Operations with a business* in the Czech Accounting Standards (CAS).

We need to mention that the U.S. GAAP and the IFRS have a character of consuetudinary law, whereas Czech accounting regulations have been codified. The essential regulation for business combinations in the Czech Republic is Act No. 125/2008 Coll., on transformations of trading companies and cooperatives, together with decree no. 500/2002 Coll. implementing Act No. 563/1991 Coll., on accounting, as amended, and CAS 011. The current wording of both ASC 805 and IFRS 3R was created in compliance with the agreement on convergence from 2002 so that their compatibility is ensured. The divergences appearing in the standards before December 16, 2008 or rather July 1, 2009, when both revised standards became effective, were removed. Therefore, we can expect smaller differences between these two standards than in comparison with the Czech approach.

The methodology has been structured into separate stages which follow each other and aim for a common goal:

1. The analysis of accounting rules relevant for the area of business combinations.
2. The comparison of selected methods according to the amended standards and regulations
 - a) in compliance with ASC 805 and IFRS 3R,
 - b) in compliance with Czech accounting principles.
3. The identification of the differences in methods for business combination among US and international accounting standards and Czech accounting regulations.
4. The evaluation of the influence of found differences on the reported financial situation and the profit or loss of a business.

From a practical perspective, the analysis and the synthesis deal with the areas which according to publications of auditing organizations of the Big Four, for details see PwC 2011 and Deloitte 2010, can significantly affect financial statements of companies entering a business combination also after its implementation. Within the business combination accounting methods they are:

- a) identification of the acquirer,
- b) establishment of the acquisition date,
- c) accounting for and measuring of gained identifiable assets, assumed liabilities and any noncontrolling interests of the acquiree,
- d) accounting for and measuring of goodwill or profit from a bargain. The evaluation of the influence of differences among the compared standards and accounting regulations on financial statements is based on literature and a theoretical solution of business combinations.

2 RESULTS

The US board for generally accepted accounting principles (FASB) and the board for international standards of financial reporting (IASB) have agreed on a broader definition of a business combination.

A transaction qualified as business combination includes more than only purchase of net assets or equity interests of a business. The revised standards define a business combination as a transaction or another process in which the acquirer obtains control of one or more businesses. Generally, the control is held by the party which directly or indirectly has over 50 percent of voting rights. IAS 27R gives several examples when control may exist if the accounting entity holds less than 50 percent of voting rights in the acquired company. A transaction or another process is only considered a business combination if the obtained net assets and the assumed liabilities together form a business. If the obtained equity is not a business, the accounting entity has to account for this transaction or another activity as a purchase of equity. Another condition is that one of the combining entities needs to be identified as the acquirer.

Within the above mentioned definition, the economic practice most often sees business combinations in the following forms:

1. An acquisition of equity interests of another business, when the acquirer purchases interests for cash or exchanges them for other assets. Thus an economic transformation occurs through which a group of legally independent but capital-interconnected businesses is created.
2. An acquisition of property, when the acquirer purchases or exchanges for other assets all net assets of another business or its part. The business continues to exist legally, yet with another owner.
3. A merger, in which one of the combining businesses assumes net assets of the other participating businesses and continues, while the other businesses are dissolved without going into liquidation. The claims of owners of the combining businesses are usually settled in the form of shares of the continuing or the newly established business.

Based on the analysis of accounting rules for business combinations and their comparison, the differences were identified and their economic consequences were evaluated and summarized in the following subchapters.

2.1 ASC 805 versus IFRS 3R

The substantial differences which were identified by comparing both revised standards for business combinations are summarised in Tab. I.

Other differences may arise due to different accounting requirements of other existing US GAAP IFRS literature (for example, identifying the acquirer, definition of fair value, replacement of share-based payment awards, initial classification and subsequent measurement of contingent consideration, initial recognition and measurement of income taxes, and initial recognition and measurement of employee benefits).

2.2 IFRS versus Czech accounting regulations

An outcome of the analysis comparing approaches in compliance with the IFRS 3R and CAR (Act no. 125/2008 Sb., on transformations, and CAS 011) is the differences, out of which we have chosen those with an impact on the economic practice. These are summarized in Tab. II.

3 DISCUSSION

The global harmonization of accounting has brought many positive results within the ongoing convergence of basic accounting and reporting principles of multinational and national accounting systems (Skálová, Podškubka, 2009). In the area of business combinations, this has been significantly promoted by the convergence agreement of 2002 concluded between the FASB and the IASB, which has, among others, led to the origination of compatible revised standards ASC 805 and IFRS 3R. In spite of this, there are differences in specific procedures between the two approaches, as the analysis has indicated. This is caused by divergent requirements which are retained in other standards related the U.S. GAAP and the IFRS. Out of the total considerable amount of possible differences we have analysed only those which can significantly affect the financial statements of an accounting entity entering a business combination. The results of the comparison, with an assessment of economic consequences presented in Tab. I, should enable analysts to quantify possible impacts on financial statements within each specific accounting transaction.

The comparison of the Czech approach with the international one has revealed many differences in details which still persist despite the immense harmonization efforts. Table II summarizes the selected differences which can significantly affect financial statements of transforming companies. The economic impact of the differences will probably depend on the specific conditions of the implemented business combination. As an example we can mention France, where 42% rise in net profits occurred in the sample of 146 large French companies after the international standards were accepted in 2005 (after the modification of financial statements in compliance with IAS/IFRS) when compared with the original French GAAP. However, as Ding, Richard and Stolowy in their publication of 2008 claim, 40% of this rise in profits can be attributed to the cancelation of goodwill amortization in favour of impairment. Similar impacts on the performance and financial situation can be expected after the mentioned differences are eliminated by Czech businesses. The proceeding global harmonization of regulations for financial statements of businesses attracts attention of national accounting regulators. Czech accounting regulations are currently being gradually harmonized with the IFRS, by means of amendments. A more radical step was taken in

I: Differences between the U.S. GAAP and the IFRS in the area of business combinations

Statement ASC 805	IFRS 3R
<p>The revised standard is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 15 December 2008.</p> <p>Summary of comparison: an earlier application of the international standard can bring an economic advantage as a consequence of the change of the original accounting. On the other hand, the prescribed criteria for allowed modifications have to be met.</p>	<p>The standard is effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first reporting period starting on or after 1 July 2009. It may also be used before this date, from the beginning of the annual reporting period which started on or after 30 June 2007. If an accounting entity uses this IFRS before its effective date, it will make this fact public and at the same time use the IAS 27.</p>
<p>Noncontrolling interest is measured at fair value, which includes the noncontrolling interest's share of goodwill.</p> <p>Summary of comparison: the variant measurement of a noncontrolling interest in compliance with the IFRS, i.e. at its proportionate share of acquiree's identifiable net assets of the assumed business means that the goodwill will not be recognised. In this way a different reporting of the financial situation of the business will occur in comparison with the reporting of the noncontrolling interest in compliance with the ASC.</p>	<p>Noncontrolling interest is measured either at fair value including goodwill or at its proportionate share of the fair value of the acquiree's identifiable net assets, exclusive of goodwill.</p>
<p>Assets and liabilities arising from contingencies are recognized at fair value, if the fair value can be determined during the initial recognition. If the fair value of a contingent asset or liability cannot be determined during the measurement period, that asset or liability should be recognized at the acquisition date in accordance with ASC 450. Contingent assets and liabilities that do not meet the recognition criteria at the acquisition date are subsequently accounted for pursuant to other literature, including ASC 450.</p> <p>Summary of comparison: the fact that contingent assets are not recognized leads to a lower balance sheet total reported in compliance with the IFRS.</p>	<p>Liabilities subject to contingencies are recognized as of the acquisition date if there is a present obligation that arises from past events and its fair value can be measured reliably. Contingent assets are not recognized.</p>
<p>If contingent assets and liabilities are initially recognized at fair value, an acquirer should develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies depending on their nature. If amounts are initially recognized and measured under the contingencies guidance in ASC 450, the subsequent accounting and measurement should be based on the same guidance.</p> <p>Summary of comparison: the methods for subsequent measurement of contingent liabilities differ, which will lead to liabilities reporting at different amounts.</p>	<p>Liabilities subject to contingencies are subsequently measured at the higher of</p> <ol style="list-style-type: none"> a) the amount that would be recognized in accordance with IAS 37, or b) the amount initially recognized less, if appropriate, cumulative amortization recognized in accordance with IAS 18.
<p>In the combination of entities under common control the receiving entity records the net assets at their carrying amounts in the accounts of the transferor (historical cost).</p> <p>Summary of comparison: an application of a similar method or acquisition method in the case of the IFRS will probably cause differences in the reported value of the transaction.</p>	<p>Outside the scope of IFRS 3(R). In practice, either follow an approach similar to U.S. GAAP or apply the acquisition method if there is substance to the transaction (policy election).</p>
<p>Control is the power to govern an entity's financial and operating policies to obtain benefits from its activities. Determining control according to U.S. GAAP: Depending on facts and circumstances, use one of the following:</p> <ul style="list-style-type: none"> ● Voting-interest model ● Risk-and-rewards model <p>Guidance can be found in ASC 810</p>	<p>For IFRS companies, the determination of control is based on an assessment of an entity's ability to direct or dominate the decision-making process and to obtain related economic benefits. Determining control according to IFRS: Consider who has:</p> <ul style="list-style-type: none"> ● Majority of voting rights ● Power to govern through agreement ● Power to appoint the board ● Power to direct operations or activities ● Decision-making authority ● Right to obtain economic benefits and bear the risk of ownership <p>Guidance can be found in the literature IAS 27R and SIC 12</p>
<p>Summary of comparison: the Standards state that for a business combination to occur, an acquirer must obtain control over a business. U.S. GAAP and IFRS define control differently. That difference may lead to divergent accounting results.</p>	

Source: PwC 2011, Deloitte 2010, authors

II: *Differences between the IFRS and CAR in the area of business combinations*

IFRS 3R	CAR
Through a business combination, the acquirer obtains control of one or more businesses. The acquisition method has to be used. The standard does not deal with business combinations under common control or an establishment of a joint venture.	CAS only deals with property acquisitions and mergers as defined in 2) and 3) of this chapter. The accounting method for acquisitions prevails but it is possible not to revalue assets and liabilities of the acquiree. Transactions of businesses under common control and transactions including non-allied parties are not distinguished, except for fully owned subsidiaries.
Summary of comparison: the possibility not to revalue assets and liabilities of the acquiree leads to possible differences in the reported financial situation of a business.	
Identifiable assets and liabilities of the acquiree which existed at the acquisition date have to be reported separately by the acquirer, regardless whether these identifiable items were reported in the accounting of the acquiree. The purchase price, assets, liabilities and contingent liabilities of the acquiree are measured by the fair value at the acquisition date. If the business assumes control by a partial acquisition of a subsidiary, it has to report full fair values of the items of equity, liabilities and contingent liabilities in the consolidated balance sheet, including shares of noncontrolling owners. Goodwill is reported.	The demand to report the items the acquiree did not report before is not explicitly expressed. The assets and liabilities of the acquiree are revaluated by the fair value in compliance with the legal form of the transaction. In some cases they do not have to be revaluated. They can be measured at their accounting value before the transaction and the measurement differences between the fair value and the accounting value will be reported as a part of the measurement difference. The acquirer can only report the assets and liabilities which were reported in the balance sheet of the acquiree.
Summary of comparison: the separated reporting of identifiable items which were not included in the balance sheet of the acquiree will affect the structure of the acquirer's balance sheet. In compliance with CAS, the identifiable items which are not included in the acquiree's balance sheet will remain hidden within the measurement difference.	
If there is a noncontrolling interest in the acquiree, it has to be reported within the fair value of net acquired identifiable assets, liabilities and contingent liabilities or as a noncontrolling proportional interest within the fair value of the acquiree. The acquirer has a choice concerning what measuring basis will be used for each separate business combination.	Noncontrolling interests need to be included in the consolidated financial statement as equity interests as of the acquisition date. The measurement of noncontrolling interests is not explicitly specified, however, they are usually measured by the fair value of the acquired identifiable assets, liabilities and contingent liabilities. In the statement, the noncontrolling interests have to be divided between basic equity, non-divided and other capital funds.
Summary of comparison: agreement emerges when net assets are measured by their fair value. If the acquirer decides to use the proportion method, the difference will be reflected in the value of reported non-identifiable assets.	
Goodwill is determined as a difference between the fair value of the acquiree and the aggregated fair value of purchased net assets (full goodwill) or as a difference between the paid purchase price and the proportion of controlled net assets measured by the fair value (goodwill related to the control packet).	Goodwill is a difference between the purchase price and the acquirer's share in the acquired net assets measured by the fair value of items. It is activated as long-term intangible assets. If the acquired assets and liabilities are accepted in accounting values, a measurement difference emerges at the acquirer's side and is a part of long-term tangible assets.
Summary of comparison: the difference in goodwill measurement appears in the acquirer's balance sheet when the method of full goodwill is used (a lower or a higher balance sum is reported).	
Positive goodwill is not amortized but its depreciation is tested annually. The test is conducted at the level of cash-generating units or a group of cash-generating units. The recoverable value of a cash-generating unit (i.e. the higher of the fair value decreased by purchase costs and utility values) is compared with its accounting value. The decrease in the value is reported as a loss in the operating result (at the amount of the accounting value excess over the recoverable value). Negative goodwill is reported in the profit and loss statement as of the moment it emerges.	Goodwill (positive or negative) is depreciated evenly into expenses or revenues for five years.
Summary of comparison: by depreciations the goodwill is removed from the balance sheet. When it is tested for depreciation it can exist without an end. The differences will be reflected in the profit and loss statement and the balance sheet of the acquirer.	

IFRS 3R	CAR
Purchase costs of an acquisition represent the amount of paid financial means or cash equivalents (or the fair value of transferred non-monetary assets), the acquirer's liabilities towards original owners and the instruments of equity issued by the acquirer. Stocks issued with the purpose of covering the price are accounted for in their fair value as of the exchange date, i.e. the date when the acquirer gains control of activities and net assets of the acquiree.	CAR does not regulate purchase costs of the acquisition. A general definition of purchase costs is used.
Summary of comparison: difference may emerge in consequence of differing concept of purchase costs, which will be reflected in the profit and loss statement.	
If information related to the establishment of fair values is gained later, the original fair values reported at the acquisition can be modified in the so-called measurement period. Subsequent modifications can only be done as error corrections.	Subsequent modifications of values of assets and liabilities are not controlled by any specific regulation. When a collection of properties is acquired, the acquirer can subsequently revalue the property based on an expert opinion and modify the accounting values accordingly.
Summary of comparison: the possibility to revalue acquired assets and liabilities individually based on an expert opinion will be reflected in an elimination of the measurement difference, which will lead to a change in the structure of the balance sheet of the acquirer.	

Source: PwC 2011, CAS 2011, authors

2005 since when Czech businesses whose securities are traded at regulated public markets have had to use the IFRS instead of the CAR to create their consolidated and individual (non-consolidated) financial statements. The other businesses can use the IFRS instead of Czech GAAP only to create their consolidated financial statements. Czech financial regulations are still an obstacle to a full use of the IFRS, accepted by France, Italy and other EU member states, as the Czech law demands the tax basis of business profits to be created in compliance with Czech accounting regulations.

4 CONCLUSIONS

The conducted comparative analysis has indicated that in spite of the long convergence efforts of the US and international boards for financial reporting standards many differences have not been removed yet and can significantly affect the reported financial situation of transforming businesses and thus also the decisions concerning mergers and acquisitions. The differences follow from specific accounting principles but also the defining concepts developed by other related standards.

The Czech legislation has been gradually accepting the changes implemented in the revised international standard. However, we feel that the effort to provide or use detailed accounting procedures still predominates instead of developing, emphasizing and applying general accounting principles and generally acceptable definitions for financial reporting. This is also the reason why the deviations found in contrast to the IFRS are more frequent and more serious as regards information significance than when we compare the U.S. GAAP and the IFRS. In fact, Czech businesses resist using the IFRS because the creation of financial statements in compliance with international regulations does not rid them of the duty to create another statement in compliance with Czech accounting regulations as this has to be used for the establishment of the tax basis. Our aim was to point out the effect of differences in accounting principles on the financial statements of businesses, which are being removed thanks to harmonization efforts but their complete removal can probably be only brought by an amendment of Czech tax regulations which will allow for a separation of accounting from taxes.

5 SUMMARY

The paper compares systems of accounting principles, the U.S. GAAP with the IFRS and the IFRS with Czech accounting regulations in the area of business combinations. The aim of the analysis is to ascertain to what degree the compatibility of these accounting regulations and principles is ensured and whether the potential differences can affect financial statements of businesses, or the strategy and timing of business combinations. The results have been summarized into two tables containing significant differences among the compared standards and accounting regulations as well as the possible economic consequences of the differences. The comparative analysis has indicated that in spite of the long convergence efforts of the US and international boards for financial reporting standards in the area of business combinations, many differences have not been removed yet and can significantly affect the reported financial situation of transforming businesses and thus also

the decisions concerning mergers or acquisitions. The differences follow from specific accounting principles but also the defining concepts developed by other related standards.

Czech legislation gradually adopts the changes applied in the revised international standards. However, we feel that the effort to provide or use detailed accounting procedures still predominates instead of developing, emphasizing and applying general accounting principles and generally acceptable definitions for financial reporting. This is also the reason why the deviations found in contrast to the IFRS are more frequent and more serious as regards information significance than when we compare the U.S. GAAP and the IFRS. In fact, Czech businesses resist using the IFRS because the creation of financial statements in compliance with international regulations does not rid them of the duty to create another statement in compliance with Czech accounting regulations as this has to be used for the establishment of the tax basis. Our aim was to point out the effect of differences in accounting principles on the financial statements of businesses, which are being removed thanks to harmonization efforts but their complete removal can probably be only brought by an amendment of Czech tax regulations which will allow for a separation of accounting from taxes.

Acknowledgements

The paper contains first results of project of Grant Agency CR No. 403/11/0447 "The Analysis of Taxation and Accounting Procedures during Mergers". The project solution, which will be conducted in 2011–2013, was entrusted to the team of the Department of Finance, Faculty of Economics and Administration, Masaryk University in Brno.

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