

COSTS OF INTRODUCING OF FULL SCOPE ACCOUNTING FOR BUSINESS COMBINATION IN THE CZECH REPUBLIC

The paper discusses implications of introducing the full accounting for business combinations in case of SMEs. Originally, the requirements were created to set accounting rules which would lead to meaningful financial reports issued after the combination by listed companies. Nevertheless, application of the core of the concept, called purchase method, might be costly for companies of the size of an SME. The expert valuation assessment is essential to allocate the price paid by the acquirer.

Moreover, the impairment tests seem to be overwhelming for understaffed or undereducated SME accountants. Also, with tax issues it is dealt in a different way (according to EU tax directives) so that accounting following the financial reporting rules would be not able to provide sufficient tax profit information without significant and costly reconciliation

International accounting standards for SMEs. There is a strong international movement towards standardizing and harmonizing accounting legislative for SMEs. The project took a particular tangible form when International Accounting Standards Board (IASB) published a Discussion Paper on its proposal to develop a separate set of international accounting standards for small and medium-sized entities on June 24, 2004. The Discussion Paper set out the IASB's preliminary views on aspects of the proposal.

Introducing the Discussion Paper, Sir David Tweedie, IASB Chairman, explained the need for developing a single set of accounting standards for SMEs:

“In most countries, many or even all entities have a legal obligation to prepare financial statements that conform to a required set of accounting principles that are generally accepted in that country. Those statutory financial statements are normally filed with a government agency and are available to creditors, suppliers, employees, government and others. The great majority of those entities are small or medium-sized entities – no matter how you define ‘small’ or ‘medium-sized’. Few countries require those entities to prepare financial statements that comply with the full requirements of the IASB's standards developed primarily for use in international capital markets. Consequently the IASB is looking for ways to simplify its standards for use by SMEs. At the same time, it will take care to adhere to the basic concepts that underlie those standards.”

The IASB website claims that it received a strong support from national standard-setters around the world on its initiative: “In September 2003, the IASB hosted a meeting of 40 of the world's national accounting standard-setters.

In preparation for that meeting the IASB surveyed them about standards for SMEs. With near unanimity, the 30 standard-setters that responded said that the IASB should develop global standards for SMEs. And nearly all indicated that their own national accounting requirements, in one way or another, already provided exemptions or simplifications for SMEs. The IASB has developed a list of some 25 disclosure and presentation simplifications and another 25 recognition and measurement simplifications already in place at the national level for SMEs in those 30 countries. IFRSs already provide several-such as exemption of unlisted companies from providing segment information and earnings per share data.”

On April 8, 2005, the IASB published a staff questionnaire on possible modifications of the recognition and measurement principles in International Financial Reporting Standards (IFRSs) for use in IASB standards for small and medium-sized entities.

The questionnaire included the following question: What are the areas for possible simplification of recognition and measurement principles for SMEs?

The IASB suggested following topics on their website:

- Measuring the cost of inventories under IAS 2.
- Use of the percentage of completion method for contracts under IAS 11 and for service revenue under IAS 18.
- Deferred income tax accounting under IAS 12.
- Lease accounting under IAS 17.
- Measurement of defined benefit pension or other post-employment benefit liabilities under IAS 19.
- Consolidation of subsidiaries under IAS 27.
- The equity method of accounting for investments in associates under IAS 28 and investments in joint ventures under IAS 31.
- Impairment approach to goodwill and intangibles for indefinite life assets under IAS 36.
- Impairment of property, plant, and equipment under IAS 36.
- Recognition and measurement of provisions and contingent liabilities under IAS 37.
- Capitalization of intangibles development costs incurred after commercial viability has been determined under IAS 38.
- Use of the effective interest method under IAS 39.
- Fair value measurements under IAS 39.
- Accounting for foreign currency forward contracts under IAS 39.
- Derecognition and/or hedge accounting provisions of IAS 39.
- The fair value method of accounting for biological assets and agricultural produce at point of harvest under IAS 41.
- Measurement of share-based payments under IFRS 2.

Surprisingly, the complex accounting for business combination was not mentioned, even if it is known that approaches to it differ in various countries significantly and it is advanced accounting issue which is often not well understood by both accountants and analysts.

Balance between Benefit and Cost. One of the crucial arguments on behalf of developing a different and simpler set of accounting standards for SMEs is that users of financial statements issued by SMEs do not require or consider to be useful such a comprehensive reporting as it is required in case of listed companies. If there is no such need recognized on the side of users there might be hardly found any benefits which would accrue to them resulting from receiving more information.

It is quite costly to implement the International Financial Reporting Standards. Besides hiring better educated and experienced staff, considerable amounts must be spent on management information systems, hiring external advisors and using more services from company's auditor.

Obviously, if the cost of obtaining the information is higher than its benefits no accounting standard should require preparers of financial statements to take an effort to gather it.

IFRSs themselves recognize this principle within their conceptual framework:

“The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgemental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared; for example, the provision of further information to lenders may reduce the borrowing costs of an entity. For these reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, standardsetters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.”

The FASB's approach to this topic is rather the same (see SFAC 2, par. 133 – 144).

Requirements of IFRS 3 Business combination:

Requirements of IFRS 3 “Business Combination” and others connected standards are complex. It, among others

– requires an acquirer to measure the cost of a business combination as the aggregate of: the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree; plus any costs directly attributable to the combination.

– requires an acquirer to recognize separately, at the acquisition date, the acquiree's identifiable assets, liabilities and contingent liabilities.

– requires the identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria to be measured initially by the acquirer at their fair values at the acquisition date.

– requires goodwill acquired in a business combination to be recognized by the acquirer as an asset from the acquisition date, initially measured as the excess of the cost of the business combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities.

– prohibits the amortization of goodwill acquired in a business combination and instead requires the goodwill to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired, in accordance with IAS 36 Impairment of Assets.

– requires the acquirer to reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the business combination if the acquirer's interest in the net fair value of the items recognized exceeds the cost of the combination.

– requires wide disclosure of information that enables users of an entity's financial statements to evaluate the nature and financial effect of the transaction made.

Benefits. Benefits of financial information are represented by the value they bring to a decision maker who uses it in order to take a successful decision. In case of SMEs the main users of their financial information are:

– Owners, who have a direct access to company's accounts and therefore the (harmonized) financial statements, are no use for them. Minor shareholders appear in much less numbers than at their listed counterparts and also they have their non-standardized access to information (usually they also would not understand a comprehensive accounting prescribed by IFRS).

– Debtors (particularly) banks have also their own channels when obtaining information. Usually they are interested in company's equity and cash.

– Governments, who are interested in company's tax payments.

– Potential acquirers; however, they always carry out their own due diligence.

– Other users (employees, public) – they might be interested but they will hardly understand the comprehensive and complex approach chosen by IFRS.

As it can be seen, there are no (or few) users who could be interested in advanced and sophisticated accounting for business combination described above. Therefore it is arguable if it can bring some benefits.

Costs. Appraisal services. The complexity of appraisals needed for correct accounting for business combination under the IFRS 3 can be seen from the following list which is an example taken from the Standard. Almost for all items fair or present

value must be found. In many cases it will be difficult as well as very expensive. For example, for financial instruments not traded in an active market the acquirer shall use estimated values that take into consideration features such as price-earnings ratios, dividend yields and expected growth rates of comparable instruments of entities with similar characteristics. Or for receivables, beneficial contracts and other identifiable assets the acquirer shall use the present values of the amounts to be received, determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary. For land and buildings the acquirer shall use market values. For plant and equipment the acquirer shall use market values. If there is no market-based evidence of fair value because of the specialized nature of the item of plant and equipment and the item is rarely sold, an acquirer may need to estimate fair value using an income or a depreciated replacement cost approach.

The actual list is very exhaustive and included as an Appendix B in IFRS 3.

Auditor's services. Undoubtedly, auditor's services are more expensive, when also the compliance with all applicable IFRSs should be audited. In case of business combination various variances in the contracted price might appear, usually unfavorable for a client.

Employees. No SME is capable of keeping an expert on accounting for business combinations. Whatever way the employer chooses to fill this gap it will be represented by huge amounts which have to be given out.

Management information system. Almost all MIS which are able to keep books in two different accounting systems must be personalized by order to fit a particular company. Due diligence and setting the software is a long process and, of course, costly.

Taxes. Many experts believe that SMEs' accounting is kept primarily for income tax purposes and that it is sufficient also for providing third party with financial information. This approach tries to avoid the need of keeping records in two different systems.

In case of business combination the gap between the tax approach and that of IFRS's is huge.

Above, some requirements of IFRS 3 were cited. In the following part, a part of Council Directive of July 23 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States (90/434/EEC) is cited:

A merger or division shall not give rise to any taxation of capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their values for tax purposes. The following expressions shall have the meanings assigned to them:

– value for tax purposes: the value on the basis of which any gain or loss would have been computed for the purposes of tax upon the income, profits or capital gains of the transferring company if such assets or liabilities had been sold at the time of the merger or division but independently of it,

– transferred assets and liabilities: those assets and liabilities of the transferring company which, in consequence of the merger or division, are effectively connected with a permanent establishment of the receiving company in the Member State of the transferring company and play a part in generating the profits or losses taken into account for tax purposes.

In other words, it means that from the tax point of view, there are usually no changes to tax value of said assets and liabilities. Or, that these changes might be very different from those required by the IFRS 3 (for example, value of net assets of different companies is taken into account in both systems).

Conclusion. In this short paper main and costly disadvantages of a full application of IFRS 3 to accounting for business combination for SMEs were mentioned. As the accounting method is very complex it turns out that both sides (preparers as well as users of financial statements) would have to spend additional effort to grasp the concept. Even after that it is still doubtful if accounting for business combination is able to deliver financial information to users which they need. Therefore, the further research whether accounting for business combination should be applied in a full extent (or should be rejected at all) should be carried out

This text was developed under the research plan title “Development of Financial and Accounting Theory and its Application in Practice from Interdisciplinary Point of View”, provider’s code MSM, RP identification code 6138439903.

LITERATURE:

1. IASB: International Financial Reporting Standards 2005. IASB, London 2005.
2. www.iasb.org.
3. www.fasb.org.
4. www.eu.int.