

How Japanese Legal and Accounting Rules Can Facilitate Business Group Restructuring

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1 Introduction

During 1991–2004, Japan suffered from long-term economic depression. In order to overcome this problem Japan eagerly and quickly introduced legal rules and accounting standards to facilitate mergers and acquisitions (M&A). M&A in this paper implies *business combinations* in a broad sense; that is, the combination of a company or a business unit with another company or business unit such that a single reporting unit is formed.

This paper explores the kinds of legal and accounting rules that were introduced in Japan and how they facilitate M&A for Japanese corporate restructuring. Japanese characteristics of these institutional supports seem to be conducive to the *restructuring of a business group*, as group behavior is one of the strengths of Japanese corporations. Such a group restructuring scheme is examined in this paper.

The authors also wish to explain that there is a consistent logic or theory among Japanese corporate law, tax law, and accounting standards that can process various types of business combination and splitting.

Especially important is the effect of new corporate tax laws on organizational restructuring. To undertake M&A by considering the earnings per share affected by the depreciation of goodwill and tax payment is a managerial accounting way of thinking.

2 Corporate Law for M&A

In order to simplify business group restructuring, Japan has created various laws for “deregulation,” benefiting the group reforms that began in 1997, as shown in Figure 1.

Stock swap is to establish a complete (fully owned) subsidiary company and is effective during business group restructuring between a parent company and a partially owned subsidiary company.

On the other hand, *stock transfer* is to establish a complete parent holding company, which will control various fully owned subsidiaries. This system is used to allow for the efficient management of a business group as well as industry comprehensive reforms that can even cover multiple consolidated business groups. A common governing company as a stock holding company can control many companies in the same business group as its subsidiaries.

Year*	Corporate law	Accounting standards	Tax laws
1997	Pure holding company		
1999	Stock swap and stock transfer	Revised consolidated financial statements	Tax law for stock swap and stock transfer
2001	Company splitting, purchase of treasury stock		Tax law for business organizational reforms
2002			Tax payment based on consolidated financial statements
2003			Revised tax law for business organizational reforms
2006	Comprehensive revision of corporate law: (a) various payment means of merger (b) simplified procedures of organizational reforms	Business combination accounting, and business splitting accounting	

* The year stands for the introductory or application beginning year.

Also note that there is other new introduction of laws for business restructurings such as the industry revitalization law, etc.

Source: Maekawa *et al.* (2005, p. 17).

Fig. 1 New laws for M&A

Company splitting is the procedure to separate a business out of a company and to make such split business a separate company. Japanese characteristics of this method can be seen in the following three applications:

- (1) establishing a new joint venture company by separating a certain business from a few companies of the same industry;
- (2) absorbing part of a business from company A into company B;
- (3) splitting a business within a consolidated business group.

In the above three cases, the first two methods are called “formation of a jointly governed company.” The third is called “a commonly governed transaction,” though this may not be considered a kind of M&A. It is noteworthy that in all these cases, neither a transfer of governance right to the absorbing company in terms of the ownership of majority vote stocks nor any effective governance relationship is observed.

3 Japanese Accounting Standards for Business Combination and Splitting

There are four types of business combinations in Japan from the viewpoint of accounting procedures (see Figure 2). These are as follows:

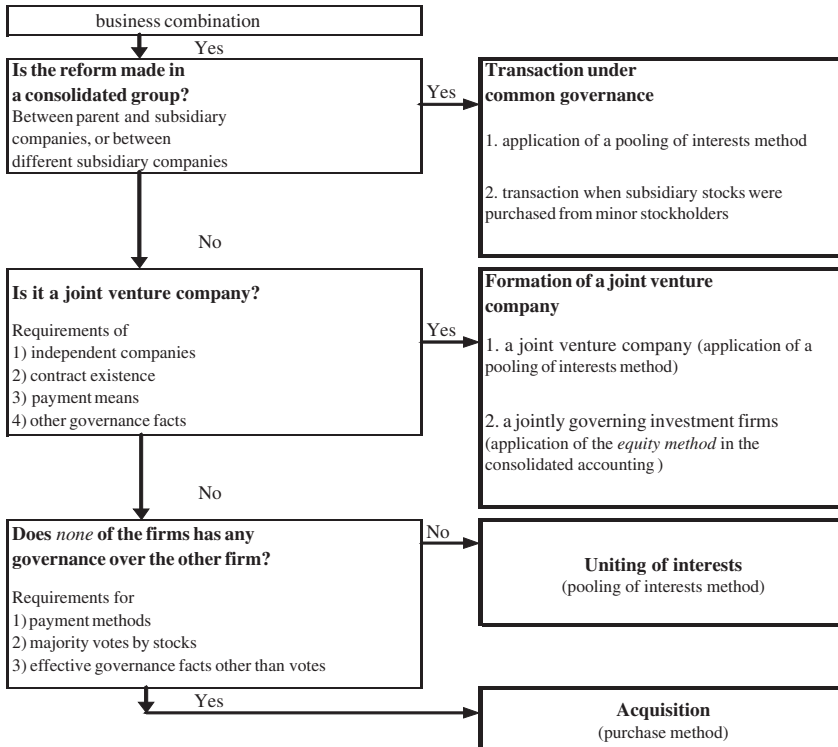
- (1) transaction under common governance;
- (2) formation of a joint venture company;
- (3) uniting of interests;
- (4) acquisition.

The first two types are original classifications of combinations unique to Japan and do not exist in the international accounting standard. They are also identified in the Japanese tax law as cases that facilitate group business restructuring from the viewpoint of tax postponement.

3.1 Concepts and identification of acquisition and uniting of interests

First, let us review how acquisition and uniting of interests differ. Difference is determined by whether the transferred assets are governed by the shareholders of the assets succeeding company or not.

In other words, *acquisition or purchase* essentially is when the majority of voting rights in the after-combination company Y is owned by the group



Adapted from FASF of Japan (2006, p. 33); also Saito (2006, p. 296).

Fig. 2 Four types of business combinations and their accounting processing

of *original* stockholders of the combining company Y, rather than the *original* stockholders group of the to-be combined company X. If the combination is an acquisition, then the top management of the acquiring company Y has *purchased* the assets transferred from the acquired company X. Thus company Y will pay for the transferred assets at *current price*. This is called the “purchase method,” by which the transferred assets and liabilities from the to-be combined company X will be valued by the current price of stock Y or both the cash and current prices of the stock paid by the combining company Y.

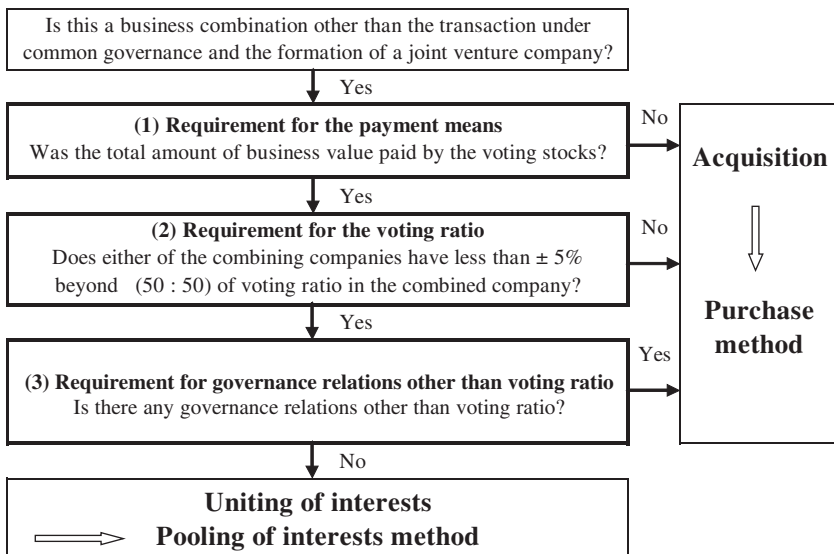
On the other hand, *uniting of interests* implies a situation where both groups of the original stockholders and both companies participate in

the merger, taking almost the same number of vote stocks in the after-combination company Y, and where neither participating company X or Y has any other effective governance power over the after-combination company. This is also called a *merger of equals*. In this situation, the assets transferred will be succeeded to the after-combination company at the *book value* of the assets of the companies before-combination. This accounting method is called the “pooling of interests method.”

Identification of acquisition and uniting of interests is summarized in Figure 3.

Most combinations in the real world are acquisitions, and pooling of interests is rare. Note that requirement (3) in Figure 3 is similar to the governance criteria that determine the scope of subsidiary companies to be included in the consolidated financial statements. This requirement includes the following four facts:

- (1) Directors or employees of either company participating in the combination have joined the board of directors of the after-combination company as its majority members.



Adapted from Accounting Standards Board of Japan (2005), No. 10 Guideline, p. 112.

Fig. 3 Identification of acquisition and uniting of interests

- (2) Based on the contract that controls important financial and operational policy-making, the group of the original stockholders of either company participating in the combination is in a stronger position.
- (3) The sale of most of the businesses of either company participating in the combination within two years is scheduled.
- (4) The exchange ratio of the stock paid for the transferred assets has deviated from the exchange ratio calculated by the current prices of the stocks of both companies, and a large premium has accrued.

The comparison between the purchase method and the pooling of interests method is summarized in Figure 4 below.

3.1.1 Valuation of goodwill

When the purchase method is applied, the goodwill that reflects the earning power of the to-be combined company will be measured by valuing the total amount of net assets or the “business value” of the to-be combined company. Suppose that A = the amount of comprehensive business value of the to-be combined company X measured by the current price of stocks or cash paid by the acquiring company Y (in other terms, the investment amount or the cost of purchase for the acquired business X), and B = the current price of

	Purchase method	Pooling of interests method
Difference in transactions	One of the combination-participating companies gains control right over the other participating company	All of the combination-participating companies continue to have their interests on equity
Types of payment means	All kinds of payment means applicable	Only stock applicable
Valuation of assets and liabilities	Current price is used only for the assets transferred from the to-be acquired company. (Book value is applied to the assets of the acquiring company)	The assets of all participating companies will be valued by the book prices
Measurement of goodwill	Yes	No
Transfer of the earned surplus and income	The earned surplus and income of the to-be acquired company will not be transferred to the acquiring company. (Only those of the acquiring company will be succeeded)	The earned surplus and income of all of the combination participating companies will be transferred

Adapted from Maekawa *et al.* (2005, p. 93).

Fig. 4 Comparison of the purchase and the pooling of interests methods

the *identifiable* assets and liabilities acquired. Then,

$$\begin{aligned} \text{Goodwill} &= A - B \text{ when } A \geq B, \text{ and} \\ \text{a negative goodwill} &= B - A \text{ when } A < B. \end{aligned}$$

Under the Japanese accounting standard for business combination the goodwill should be constantly amortized within 20 years as well as impairment written off. Also the Japanese tax law regulates constant depreciation for a fixed five years as of year 2006. These rules play a negative role in the amount of EPS (earnings per share), so shareholders may be inclined to say “No” to an M&A that would be accepted by Western stockholders. On the other hand, for the case of “negative” goodwill, the response of Japanese shareholders may be opposite, because depreciation of negative goodwill contributes to an increase of non-operating profit.

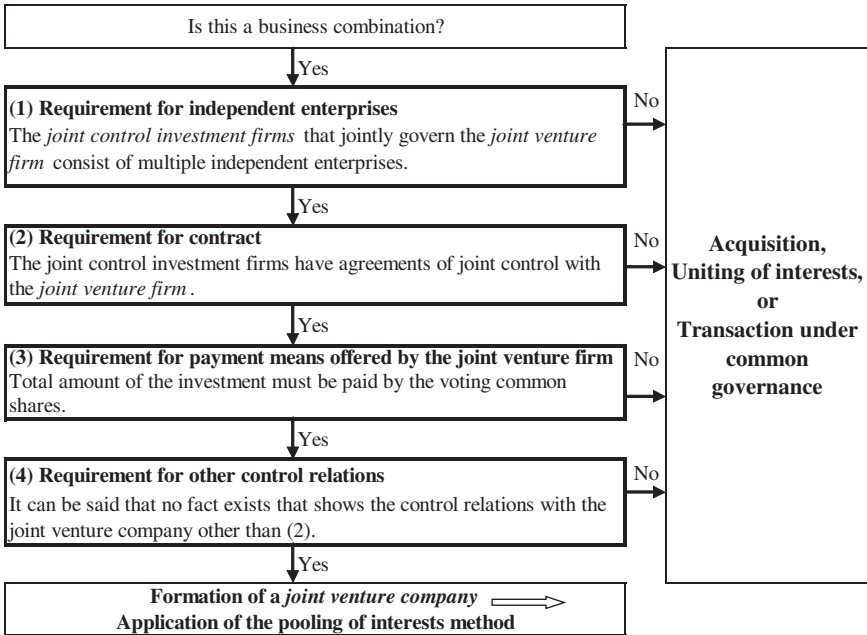
3.2 Formation of a joint venture company

Japanese business combination accounting specifies accounting rules for the joint venture company and the joint-controlling investment companies of the joint venture. A joint-controlling investment company looks similar to uniting of interests, but they are not identical.

Uniting of interests is the merger of equals, with the original merger participating companies ceasing to exist after the merger is complete. However, to establish a new joint venture, the joint-control companies split off some business. The original combination participating companies continue to exist and receive stocks of the new joint venture company as payment for their transferred business, which are recorded on the balance sheet as an investment account. Therefore the joint venture is an *associated* company of the joint-control investment firms, which satisfies all of the requirements given in Figure 5.

Regarding accounting procedures, the newly built joint venture will apply the pooling of interests method, while the joint-controlling investment firms will value the transferred net assets by book value and hold the investment account (stocks of the joint venture) as stated above.

Because the joint-control companies do not cease to exist, they may prepare consolidated financial statements that include the said joint venture. In this case they handle the “investment account” by the *equity method*.



Adapted from Accounting Standards Board of Japan (2005), No. 10 Guideline, p. 113.

Fig. 5 Formation of the jointly controlling investment companies

3.3 Transaction under common governance

This combination is the merger between parent and subsidiary companies, or the merger between subsidiaries, etc.

All of the merger-participating companies are eventually controlled by the same company (i.e., a parent company as the majority shareholder) before and after the merger in question. As such, this combination is an internal transaction within a business group, and thus the transferred assets and liabilities are evaluated by the book value. However, in the consolidated financial statement of a parent company that is the common controller, the investment of the parent and the equity of subsidiary must be offset (Figure 6).

Another item included in the transaction under common governance is the transaction when the parent company additionally purchases the stocks of the subsidiary company from minor stockholders. This is an external transaction outside the group and is not a merger. The additionally acquired

	Variety of mergers	Classification of business combinations	Accounting procedures	
			Single company financial statements	Consolidated financial statements
Type 1	Merger between parent company and subsidiary company	Transaction under common control	Book value	Off setting
Type 2	Merger between parent company and the less than 100% owned subsidiary	Transaction under common control	Book value	Off setting
Type 2'	Among the merger type 2, the parent company offers its treasury stocks to the minor shareholders of the subsidiary	Transaction under common control (transaction with minor shareholders)	Valuation of the additionally acquired subsidiary stocks by the current price	Idem as above. Goodwill or negative goodwill on the balance sheet
Type 3	Merger between subsidiary companies	Transaction under common control	Book value	Off setting
Type 4	Merger between investment firm and associated firm	Acquisition, uniting of interests, or formation of a joint venture company	Methods based on each category of business combinations as left	

Adapted from FASF of Japan (2006, p. 43); also from Saito (2006, p. 305).

Fig. 6 Transaction under common governance

subsidiary stock of the parent company must be valued on a balance sheet at current price. On the consolidated balance sheet of the parent company, however, the goodwill is measured as the difference between the current price value of the additional stock acquired and the minority share equity recorded on the consolidated B/S before the said additional acquisition.

4 Japanese Corporate Tax Law Facilitating M&A

Ordinary M&A are processed by evaluating the transferred assets with their current prices so that the *asset transfer income* accrues in the asset transferring company whenever the current price is greater than the book value (except when there is a big deficit in the company). As a result, the asset transferring company will suffer from cash-outlay due to the tax subtraction from the asset transfer income. Thus, through this merger, organizational restructuring is discouraged.

Therefore the tax authority has introduced the *competent* taxation system that allows the asset transferring company to be exempt from immediate taxation of the asset transfer income of certain types of mergers and

business splittings, etc. Such competent M&A can transfer assets by applying *book value*.

4.1 Incompetent taxation system

Business combinations that are *incompetent* to the taxation postponement system are summarized in Figure 7. There are two kinds of incomes:

First, taxation on “asset transfer income” is applied to the asset transferring merged company so long as the merger is, in effect, an “acquisition” made by the merging company. In this case, the transferred asset is actually sold to the stockholders of the merging company with the new stock paid at the current price. This is same as the *purchase* method in the accounting standard.

Second, there are two categories of the stockholder income of the merged company. The first type is “stock transfer income” gained by the stockholders who rendered their stock and other assets to the acquiring company. If only the stock is rendered as a stock swap, then the stock transfer income is not recognized. But if cash is also paid, then the stock transfer income is recognized, since this gain is realized by a cash reception. The second type is “delivery of the earned surplus regarded as dividend” (abbreviated as “regarded dividend”) to the stockholder. This is due to the understanding that the earned surplus of the merged company will not be succeeded to the acquirer because the earned surplus is retained as a result of operating activities of company X and should be redeemed to company X stockholders.

Taxation objects	Procedures	
	Incompetent taxation system	Competent taxation system
Merged company	The asset transfer income will be recognized by the current price transfer	The book value transfer will not recognize the asset transfer income
Merging company (acquirer)	Earned surplus of the merged company will not be succeeded to the acquirer	Earned surplus of the merged company will be succeeded to the acquirer
	Delivery of the earned surplus regarded as dividend will be recognized	Delivery of the earned surplus regarded as dividend will not be recognized
Stockholders of merged company	(When cash is also offered)	(When only stock is offered)
	Stock transfer income is recognized	Stock transfer income is not recognized
		(Only stock will be offered)
		Stock transfer income will not be recognized

Adapted from TAC Corporation tax law section (2004, p. 13 and 24).

Fig. 7 Incompetent taxation system and competent taxation system

4.2 Competent taxation system

Business combinations that are *competent* to the taxation postponement system are summarized in Figure 7. Suppose that both of the merger participating companies X and Y send their directors of the board to the merging company Y as directors with effective control rights in company Y. In such case, the merged company X also continues to keep control of the financial and operation policy-making in the new merging company Y. The *pooling of interests method* is then applied, and thus none of the *assets transfer income*, *regarded dividend*, and *stock transfer income* are recognized.

It is important to note the effect of taxation postponement on organizational restructuring. To select the form of M&A by considering the earnings per share as affected by the tax payment system is a managerial accounting way of thinking.

4.2.1 Merger within a consolidated business group

The following cases are similar to *transactions of common governance* in the Japanese accounting standard for combinations:

- (1) a merger between companies with 100% ownership;
- (2) a merger between companies with more than 50%, but less than 100%, ownership.

These cases are seen in the mergers between parent and subsidiary companies or between the brother and sister subsidiary companies. The following two requirements must also be satisfied:

- (a) More than 80% of employees of the merged company are succeeded to the merging company.
- (b) The main business of the merged company is succeeded to the acquirer.

4.2.2 Merger as a joint venture

This is similar for a company of *joint control* and *uniting of interests* in the Japanese accounting standard of combinations. In order for a joint venture to be competent to the taxation postponement, the following four conditions must be satisfied. Although the terminology *uniting of interests* is not used in the Japanese corporate tax law, this type of business combination can be included as the uniting of interests, by considering the requirements

below:

- (1) **Requirement of mutually related businesses:** The merger participating companies have a mutually related business.
- (2) **Requirement of similar scale of business or the joint participation in the new company by the existing directors:** The business of the acquirer must not exceed more than five times the business transferred from the merged company.
- (3) **Requirement of employee transfer** (the same as a merger within a consolidated business group).
- (4) **Requirement of main business succession** (the same as a merger within a consolidated business group).
- (5) **Requirement of successive holding of stocks:** The majority of shareholders before the merger continue to be stockholders after the merger.

4.3 Numerical examples of mergers handled by the tax law

Incompetent and competent taxation systems are examined using the numerical example in Figure 8.

4.3.1 Numerical example of an incompetent taxation system

Based on the example given in Figure 8, first let us assume that *acquisition* of assets of the merged company X is carried out by the merging company Y, in consideration of the *smaller* number of voting common stocks given to the current shareholders of company X and the *greater* number of stocks held by the current stockholders of company Y. Therefore this is an incompetent merger.

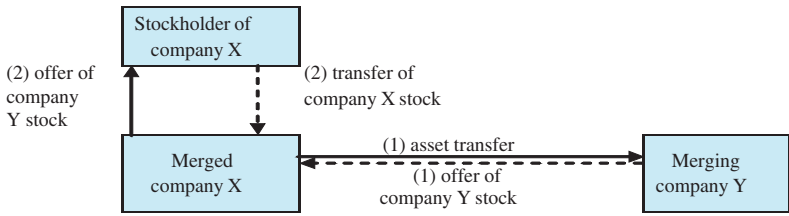
4.3.1.1 Handling of the merged company X

(Step 1) Company X sells its assets for a total amount of 32,000 at the current price of the company Y stock. Thus,

(Dr.)	company Y stock	32,000	/	(Cr.) assets	24,000
				assets transfer income	8,000

Tax is charged to this assets transfer income, which is added to the earned surplus of company X (strictly speaking after deduction of tax):

(Dr.)	assets transfer income	8,000	/	(Cr.)	earned surplus	8,000
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(Note) Total amount of current price of company Y stock = 32,000
 Increased amount of capital of company Y = 16,000

Balance sheet of company X before merger			
assets *	24,000	capital	16,000
		capital surplus	6,000
		earned surplus	2,000

* total amount of the current price of assets of company X, or the value of company X = 32,000

Balance sheet of company Y before merger			
assets	44,000	capital	30,000
		capital surplus	10,000
		earned surplus	4,000

Fig. 8 Numerical example of a taxation system

(Step 2) The company Y stock is immediately given to company X shareholders in exchange for their company X stock, which disappears at the same time.

(Dr.) capital	16,000	/	(Cr.) company Y stock	32,000
capital surplus	6,000			
earned surplus	10,000			

(Step 3) Changes in the balance sheet of company X are shown in Figure 9.

4.3.1.2 Handling of merging company Y

Company Y receives the assets provided by company X stockholders at the current price of 32,000 and as a result increases its capital and capital surplus as follows:

- The predetermined incremental amount of capital = 16,000
- The incremental amount of capital surplus = 16,000
- = incremental assets 32,000 – incremental capital 16,000

B/S of company X before merger			
assets	24,000	capital	16,000
		capital surplus	6,000
		earned surplus	2,000
		↓	
B/S of company X during merger process			
company Y stock*	32,000	capital	16,000
		capital surplus	6,000
		earned surplus	10,000
		↓	
B/S of company X after merger			
		(disappeared**)	

* Company Y stock was offered

** Company X disappeared after giving stock Y to the stockholder X.

Fig. 9 Changes in the balance sheet of company X

(Dr.)	assets	32,000	/	(Cr.)	capital	16,000
					capital surplus	16,000

As a result, changes in the balance sheet of company Y are shown in Figure 10.

B/S of company Y during merger			
assets	44,000	capital	30,000
		capital surplus	10,000
		earned surplus	4,000
		}	original assets, etc. of company Y
assets	32,000	capital	16,000
		capital surplus	16,000
		}	purchase from company X by capital increase
sum	76,000	sum	76,000
		↓	
B/S of company Y after merger			
assets	76,000	capital	46,000
		capital surplus	26,000
		earned surplus	4,000
sum	76,000	sum	76,000

Fig. 10 Changes in the balance sheet of company Y

4.3.1.3 Handling of company X stockholders

(1) Regarded Dividend

Company X shareholders receive the amount of the net assets valued at the current price of the company Y stock; this amount includes *earned surplus*

as a regarded dividend. As in this numerical example only the stock of Y was given to the shareholders of X, it follows that

$$\begin{aligned} &\text{Procurement amount of company Y stock} \\ &= \text{book value of company X stock} + \text{regarded dividend.} \end{aligned}$$

(Dr.)	company Y stock	36,000	/	(Cr.)	company X stock	26,000
					regarded dividend	10,000

In this example, the total amount of *regarded dividend* is equivalent to the total amount of earned surplus of company X. However, if the merging company Y also had a part of the company X stock, the regarded dividend should be allocated to both stockholders X and Y in proportion to their share of the holding stock numbers.

(2) Stock Transfer Income

So long as the stockholders of company X are given the cash (excluding the regarded dividend) as well as the stock of company Y, it means they have gained stock transfer income when they rendered their own stock as a stock exchange.

In the above numerical example, suppose stockholders of company X receive 2,000 cash and the stock of company Y equals 30,000 at current price. Then, stock transfer income = total amount of payment from company Y (30,000 + 2,000) – regarded dividend (10,000) – book value cost of the stock rendered (26,000).

(Dr.)	stock of company Y	30,000	/	(Cr.)	stock of company X	26,000
	cash	2,000			regarded dividend	10,000
	stock transfer income	4,000				

Here, the amount of the company Y stock (30,000) is measured as the amount considered necessary for acquisition. When only stock is offered by company Y as payment, it means latent profit is included in the amount of stock of company Y, although not recognized.

4.3.2 Numerical example of the competent taxation system

In the above numerical example, suppose that both companies X and Y send their board of directors to the merging company Y as directors with effective control rights in company Y. In such a case, neither the assets transfer income, the regarded dividend, nor the stock transfer income will be recognized.

4.3.2.1 Handling of merged company X

(Step 1) The stock of company Y is offered as a payment to the transferred net asset 22,000 (= book value 24,000 – transferred earned surplus 2,000).

(Dr.) stock of company Y 22,000 / (Cr.) assets 24,000
 earned surplus* 2,000 /

*In the case of the competent taxation, the earned surplus is transferred to merging company Y.

(Step 2) Company X offers stock of company Y, which is equivalent to the total amount of owner’s capital minus the transferred earned surplus, to their stockholders X.

(Dr.) capital 16,000 / (Cr.) company Y stock 22,000
 capital surplus 6,000 /

(Step 3) Changes in the balance sheet of company X are as follows (see Figure 11).

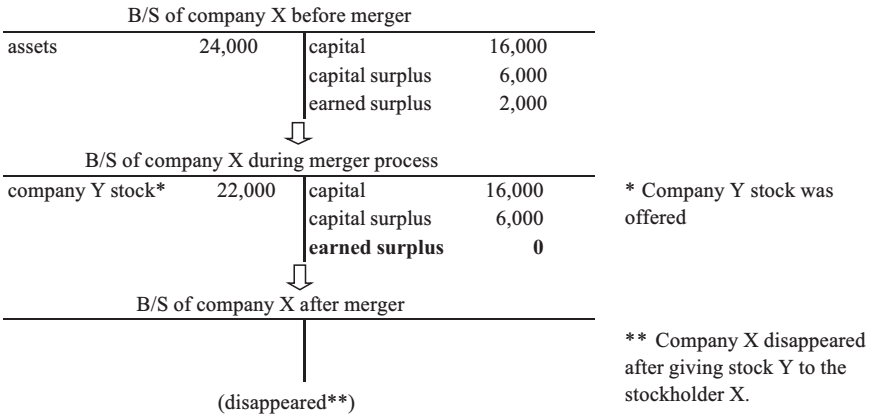


Fig. 11 Changes in the balance sheet of company X

4.3.2.2 Handling for merging company Y

Merging company Y receives the assets from company X at book value 24,000, as well as succeeding its earned surplus 2000.

(Dr.) assets 24,000 / (Cr.) capital 16,000
 capital surplus 6,000
 earned surplus 2,000

B/S of company Y during merger				
assets	44,000	capital	30,000	} original assets, etc. of company Y
		capital surplus	10,000	
		earned surplus	4,000	
assets	24,000	capital	16,000	} succeeded from company X by capital increase
		capital surplus	6,000	
		earned surplus	2,000	
sum	68,000	sum	68,000	
↓				
B/S of company Y after merger				
Company Y Stock	68,000	capital	46,000	
		capital surplus	16,000	
		earned surplus	6,000	
sum	68,000	sum	68,000	

Fig. 12 Changes in the balance sheet of company Y

where the capital surplus 6,000 = (assets 24,000 – earned surplus 2,000) — capital 16,000.

Thus, changes in the balance sheet of company Y are shown in Figure 12.

4.3.2.3 Handling for the company X stockholders

Because this is a taxation *competent* case, neither regarded dividend nor stock transfer income is recognized. Therefore, the cost of acquiring company Y stock is equivalent to the book value of the original stock of company X:

(Dr.) company Y stock 26,000 / (Cr.) company X stock 26,000

5 Conclusion

Among the various types of business combinations, the rules for *transaction under common governance* and *formation of a joint venture company* are unique to Japan and do not exist in international and US accounting standards.

A transaction under common governance is a merger between a parent and subsidiary companies or a merger between subsidiaries. These combinations are made within a certain consolidated business group and are implemented in order to *restructure* the business group. To facilitate such

group restructuring, these types of combinations are handled by *the pooling of interests method* in the Japanese accounting standards and tax law.

Formation of a joint venture company is divided into two types: In the first type, the original merger-participating companies cease to exist after the merger, while in the second type, the original companies continue to exist and merely split off part of their businesses and establish a new joint ventures.

The pooling of interests method is applied to such a joint venture company if certain requirements are satisfied. This handling also vitalizes Japanese group reorganization through the achievement of quick decision-making by the managers of such joint ventures.

Furthermore, the authors would like to emphasize that there is a consistent logic among the Japanese corporate law, accounting standards, and tax law. During the past 10 years the Japanese corporate law has been deregulated to encourage business group restructuring by allowing a holding company, stock swap and stock transfer, company splitting, various payment means for transferred assets in the merger, etc. While Japanese accounting standards recognize the pooling of interests method for combinations of group restructuring, as stated above, the Japanese tax law has also eased conditions for similar combinations such as group restructuring or a joint venture through the postponement of immediate taxation on *asset transfer income* and *stock transfer income* by allowing the *pooling of interests method*.

The various applications of the pooling of interests method mentioned above can enhance the value of an after-merger company since EPS can be more increased than the purchase method due to no effect of goodwill-depreciation under the book value, thereby encouraging and boosting group restructuring and formation of a joint venture in the Japanese business world. However, the situation is reversed when a “negative” goodwill occurs through the purchase method.

Another character of Japanese business combinations lies in the handling of goodwill that appears when the purchase method is applied. Japanese accounting standards and tax law are both stricter in terms of the depreciation method for the “positive” goodwill, and more relaxed in the depreciation method for the “negative” goodwill than Western countries, because the Japanese accounting standard forces constant depreciation for 20 years or less and the Japanese tax law for fixed five years, respectively. The western purchase method is similar to the

Japanese pooling of interests method when seen from the income statement since their purchase method allows no periodical depreciation of goodwill.

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