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Accounting Problems Encountered in M&As

Yasuyoshi Kurokawa
Professor, Faculty of Commerce, Senshu University

1 Introduction

In recent years, with the sudden spread of globalization and the rapid accumulation of business information, companies are forced to cope with a growing number of emergency situations. Accounting standards for business combinations in Japan have been announced in the "Opinion on the Establishment of Accounting Standards for Business Combinations" issued by the Business Accounting Deliberation Council in October, 2003. The "Accounting Standards for Business Combinations" based on this opinion have been applied from the accounting period beginning on April 1, 2006.

This opinion is based on the idea of government fostering of enterprises with international competitive power. It proposes the reorganization of international enterprises in particular. In addition, it encourages the harmonization of Japanese accounting standards with international accounting standards. By international accounting standards, this paper refers to the International Financial Reporting Standard (IFRS) published by the International Accounting Standards Board (IASB) and the Statement of Financial Accounting Standards (SFAS) published by the Financial Accounting Standards Board (FASB). By approximating these international standards, it is expected that the capital market of our country will be reactivated and that the globalization of enterprises will progress.

The activation of the capital market is not achieved only through examination of M&As; however, it is achieved by joining M&A

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accounting with corporate governance. Taking into consideration the interests of all stakeholders simultaneously, we will clarify the process of globalization of the capital market in Japan and the ideal method of governance through an examination of M&A accounting.

2 The Present Conditions of M&A Accounting in Japan: Stepping toward International Harmonization

The Financial Accounting Standards Board (FASB) in the States did not adopt the *pooling of interests* method, but the *purchase* method for business combination in its Statement of Financial Reporting Standards No. 141, "Business Combinations," issued in June 2001. And in the case of a merger of equals, the FASB examined the possibility of adopting the *fresh start* method, because it is unknown which is the acquiring company (SFAS No. 141, paragraph B32) (Kikuya, 2007, p. 18). However, the IASB published IFRS No. 3 to force the purchase method through in March 2004; this statement is an example of the American disregard of the fresh start method.

The Japanese Accounting Standards for Business Combinations have recognized the pooling of interests method, while assuming the purchase method basics. Because we cannot distinguish the acquiring company from the acquired one, the pooling of interests method is used in order to circumvent the limitations inherent in commercial law. According to commercial law, we cannot replace a continuing company with a company legally becoming extinct. It follows that the pooling of interests method did not disappear as a means to absorb the value of the company which continues. In adopting the purchase method, the standard of our country basically follows the same path as the international trend. However, the Japanese standard is slightly different from the international one in its application of the purchase method.

The Japanese Accounting Standards for Business Combinations gives control to both the controlling company and the controlled company in the same way. The rule does not have to make it clear which is the controlling company. However, even if the purchase method is adopted for this reason, the pooling of interests method is also accepted. The IFRS adopts the purchase method with the highest

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precedence from the viewpoint that either company is in control. In this sense, SFS No. 141 and IFRS hold the same stance.

When we define acquisition in our country, we ordinarily mean anything other than a situation satisfying all of the three matters listed below (Accounting Standards Board of Japan (ASBJ), Accounting Standards for Business Combinations III-1- (1), 2004):

1. The counter value is represented by stocks with voting right.
2. The voting rights are equal.
3. The condition that the acquisition reflects all controlling relations except the voting right ratio is not satisfied.

But, only when the points 1 and 3 in the above list are satisfied, the resulting merger is treated as a synarchy company and it becomes a combination of the participating equities (ASBJ, Accounting Standards for Business Combinations III-1- (2), 2004).

When a business combination occurs in which there is counter value other than stocks with voting right, the company that expends counter value becomes the acquiring company, and when the counter value consists of stocks with voting right, the company that has the larger voting right ratio becomes the acquiring company. When the voting right ratio is equal, the matter is judged based on control-related facts. The control-related facts are recognized to imply control if, among the following four conditions, even one holds:

1. Constituting the majority of members of the decision-making body.
2. Having the decision-making right with regard to financial affairs and management policies.
3. Getting rid of most of the business within two years.
4. The exchange ratio of stocks to be issued for the counter value is estranged with the exchange ratio calculated based on the current price, and a large premium is paid.

The IFRS defines the acquiring entity as "the company with dominance." It is assumed that the dominance consists of having various types of authority (IFRS, paragraphs 17–19). As for authority, the following characteristics are assumed (ASBJ, Accounting Standards

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for Business Combinations "2 of accounting standards" III-1- (2), 2004):

1. The majority of the voting right is held.
2. The decision-making right with regard to financial affairs and management policies is held.
3. The majority of the voting right of the majority of the governing bodies is held.
4. The majority of the voting right of the governing bodies is held (ASBJ, Accounting Standards for Business Combinations, Explanatory Notes, Note 4, 2004).

However, when identifying the dominant company, this issue is sometimes unclear at the time of M&A. Therefore, the IFRS defines dominance, i.e., the acquiring entity, based on the following three criteria:

1. When the fair market value of a certain company is remarkably larger than the fair value of the other company, it is obvious that the larger company is the acquiring entity.
2. When M&A is carried out by means of cash or other assets in exchange for the voting right common stock, it is obvious that the company that hands over the cash or other assets is the acquiring entity.
3. It is obvious that the company whose manager becomes the manager of the company resulting from the M&A is the acquiring entity.

The aim of the IFRS is to make it clear which is the controlling company, as discussed above, and to discourage the unification of interests into a synarchy as a result of not correctly identifying the controlling company.

The FASB regards the company which hands over assets for the counter value or takes over the debt as the acquiring entity (FASB, 2001, SFS No. 141, paragraph 16). However, in the case of a stock swap, the company publishing stocks may not be the controlling company, because a controlled company can also publish stocks. The

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controlling company is distinguished by the situation of the voting right after the combination, the governing bodies, the administration structure, and the bargaining points of the equity security (FASB, 2001, SFS No. 141, paragraph 17).

The accounting standards of the IFRS and SFS focus on the identification of the acquiring entity. In contrast, the Japanese accounting standards consider both sides, i.e., the acquiring entity as well as the acquired one.

The next problem when the controlling company becomes an acquiring entity is how it calculates the cost the acquired entity. The acquiring entity assumes as the historical cost the total amount of money corresponding to the fair value of the assets and liabilities of the acquired entity and the accompanying additional expenses at the time of acquisition. In this regard, SFS No. 141, IFRS No. 3 and the Japanese Accounting Standards for Business Combinations are similar.

However, the calculation of the historical cost when the acquiring entity publishes the equity securities held in the acquired entity is slightly different in SFS No. 141, IFRS No. 3, and the Japanese standards.

IFRS No. 3 takes the price as of the day of exchange of the securities (acquisition date model) (paragraph 27). However, in Japan, this situation is handled as an exception. In other words, the acquisition date model takes the price on the acquisition day when the stock prices on the stock swap day are not widely different from the stock prices before the agreement/publication date of the main condition of the M&A. In principle, the Japanese accounting standards adopt the agreement date model, in that the main conditions of the M&A are agreed upon and the stock prices announced several days prior are taken as valid (ASBJ, Accounting Standards for Business Combinations III-2- (2), (3), 2004).

SFS No. 141 clarifies the main condition: the stock prices that are announced within a reasonable period before and after are taken as valid; however, the stock prices announced several days prior are not valid. On this point, there is a slight difference between the SFS and the Japanese standards; however, the agreement day model is straightforward and easily applied (Kikuya, 2007, p. 25).

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The acquiring entity recognizes the identifiable assets and liabilities of the acquired entity at their fair market value on the acquisition day and makes the cost allocation after the business combination according to the respective assets and liabilities for the year ahead. When the legal right and the transferable intangible assets are included in the acquired assets, the relevant intangible assets can be allocated by the cost. The timing of the recognition of the liabilities is as follows. The expense or loss for which accrual is predicted in the short term after the acquisition, as well as the possibility of accrual, is reflected in the calculation of the acquisition price. In this way, the Japanese standard isolates the cost allocation of the acquired entity over the one-year period after the acquisition and it recognizes the fair value of the assets and liabilities on the acquisition day. However, evaluation of concrete and the identifiable assets and liabilities is necessary for the determination of the fair value of the acquired entity. Regarding assets and liabilities, it will be necessary to apply the replacement cost, the estimated amounts that subtracted the amount of profit equivalency, the sale expense from the market value, the present discount value, and the selling price as per IFRS No. 3 and SFS No. 141.

The Accounting Standards Board of Japan, which has taken over the work of the Business Accounting Deliberation Council, revises the accounting standards for M&As, and the next standard will become valid in April 2010. The revised standards will consist of the following:

1. Corporate Accounting Standard No. 21, Accounting Standards for Business Combinations.
2. Corporate Accounting Standard No. 22, Accounting Standards for Consolidated Financial Statements.
3. Corporate Accounting Standard No. 23, partial revision of the Accounting Standards for Research and Development Expenses.
4. Revision of Corporate Accounting Standard No. 7, Accounting Standards for Business Separations.
5. Revision of Corporate Accounting Standard No. 16, Accounting Standards for the Equity Method.

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6. Revision of the Guideline for the Application of Corporate Accounting Standard No. 10, Guideline for the Application of the Accounting Standards for Business Combinations and Accounting Standards for Business Separations.

The most important characteristic of the new standard is that it abolishes the pooling of interests method, in which the acquiring entity takes over the assets and debts of the acquired entity at their book value. When the purchase method is adopted, goodwill is generated. That is to say, on the side of the acquiring entity, when the historical cost is unequal to the sum of the assets of the acquired entity and the liabilities undertaken, the surplus is entered in the assets column as *goodwill* and the deficiency is entered in the liabilities column as *negative goodwill*.

Until now, depending on the actual situation of the acquisition, the negative goodwill was written off regularly over a period of 20 years and entered as non-operating profit. However, with the new standard, it will be entered as an *extraordinary gain* in the year when it is purchased. In other words, the negative goodwill is extinguished by applying the *immediate reversal* method.

In addition, the acquiring company used to treat [what] as an expense at the time of cost allocation; we used to treat a part of the historical cost, including the cost of software, as research and development expenses. However, it was treated as an asset if a certain condition was satisfied, and expense processing came to be widely accepted.

When the acquiring company issued stocks in exchange for the value of the acquisition, the current price of the property was based on the stock prices before the day when the main condition was agreed upon and the combination was announced.

However, the new Japanese accounting standards acknowledge the current cost on the day of the M&A or the day of separation of a business. In other words, when stocks are issued for the value of the acquisition, the standard of our country will change from the agreement day model stipulated in SFS No. 141 to the acquisition day model expressed in IFRS No. 3.

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Positive goodwill is appropriated together with the assets and it is amortized regularly over a period of 20 years by the method of fixed installment and others. The amortization of goodwill is included in the selling expenses and administrative expenses, but it cannot be put down to special losses except in the case of impairment loss. When the amount acquired goodwill is negligible, it can be treated as an expense and displayed as a selling expense or administrative expense. The non-amortized balance of goodwill becomes the object of impairment treatment and, in this case, there must be a sign of the impairment in the M&A year.

Regarding the sign, there are cases in which the amount of money allocated to intangible assets other than goodwill is large, and a large premium is paid. When impairment loss of goodwill is recognized, it is entered in the special losses section.

According to the new standard, positive goodwill will be amortized regularly and impairment accounting is limited when a sign of the impairment is seen in the M&A year. This is different from the international trend reflected in International Financial Reporting Standard No. 3 (IFRS3) of the IASB and Financial Accounting Standard No. 14 (SFAS14) of the AFASB. In other words, the assets which are appropriated as assets are measured as the amount of money resulting from the subtraction of the total impairment loss. The assets are not amortized regularly, but an impairment test must be conducted every year.

Therefore, the IASB and FASB require that regular amortization be subtracted from the assets which are appropriated as assets, and that only the impairment test method be adopted (Kikuya, 2007, p. 25).

In addition, when preparing the consolidated financial statement, the *purchased goodwill* method, namely the *partial current cost* method, which reflects only the minority interests in the evaluation of the assets and liabilities of the subsidiary, will be abandoned. Instead, the *full goodwill* method will be introduced in the new standard. This method is also called the "*full current cost evaluation*" method and it evaluates the assets and liabilities of all subsidiaries at the current cost on the acquisition day (Consolidated Accounting Standards of Japan, Article 20).

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In other words, the fair value of the subsidiary is established for all assets of the subsidiary; not only for the identifiable assets and liabilities but also for the unidentifiable ones. Goodwill is also included in the fair value evaluation of a non-controlling shareholder's equity. It is said that this accounting treatment harmonizes with the economic unit concept. Goodwill recognized based on identifiable assets is distributed proportionally over the non-controlling shareholder's equity and, even if not all the equity is acquired, all of it is evaluated based on the fair market value, including the non-controlling shareholder's equity. The reason for this is that there is no difference between the way of handling the parent company's equity and that of handling the minority interests. Adding the internally generated goodwill accompanying the non-controlling shareholder's equity and the reliability of goodwill measurement in the full goodwill method is pointed out as problematic (Kikuya, 2007, p. 28).

3 The Revision of the Accounting Standards for Business Combinations: Toward Convergence

The M&A accounting standards of our country, in which the pooling of interests method is abolished and the purchase method is introduced, face the problem of whether have only to say that the globalization of merely accounting standards is submitted.

The following is often given as grounds for adopting the pooling of interests method. After a business combination, the equities of the parties simply continue to exist in the same mutual ratio and the settlement of investment and reinvestment is not to be it. However, one reason for supporting the purchase method is that this method lacks validity because it allows for a change in quality of the equity. But the change in quality of the equity is accepted by both sides, and in pooling the interests, it is argued against the adoption of the purchase method (Mandai, 2003a).

This is relevant in investment decision making, because the pooling of interests method, which recognizes assets and liabilities at book value and ignores predicted cash flow, lacks purpose adaptability. It is thought that the investment decision-making utility lacks relevance. Even if the cash flow in the future will reflect the fair

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value of the assets and liabilities and the purchase method discloses the absolute amount of the share, the cash flow in the future cannot be known today, because it is not the absolute sum of the share, but is calculated based on the profit realized in the future. The corporate value is calculated by discounting future profit and future cash flow from the realized profit. Therefore, there is no ground for adopting the purchase method (Mandai, 2003b).

In addition, there are dissenting opinions regarding the fact that goodwill is not amortized or handled as impairment. There is no objection to the idea that unidentifiable assets bring future economic benefit in the form of goodwill. However, the following three issues are examined when determining whether goodwill should be amortized or handled as impairment or not.

1. The combination of regular amortization and impairment.
2. Non-amortization and impairment.
3. The combination of points 1 and 2, (i.e., regular amortization and impairment and non-amortization and impairment).

Of these, point 3 will be rejected from the standpoint of the comparability of financial statements. As for point 1, regular amortization is objected to because it is only an arbitrary estimate, which makes it uncertain whether the amortization cost of the goodwill is economical or not. However, there is no reason to reject the regular amortization of goodwill even if regular amortization is an arbitrary estimate. In addition, the amortization cost of goodwill is economical, as long as we recognize that the value of goodwill in itself, as excess earning power, decreases slowly.

If a strict and feasible impairment test is possible, it becomes a useful processing method. It is not feasible to test often when we see a sign of the impairment.

Even if this impairment test takes the book value of the goodwill and compares it with the presumed price, it is not a strict and feasible impairment test, because internally created goodwill may enter the tested data (Mandai, 2003b). We must recognize internally created goodwill if we are going to adopt the point 2 given above. It may be said that it is not a stage to recognize internally created goodwill, as

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long as we choose point 1, the combination of regular amortization and impairment, and not point 2 in the new standard.

3.1 *M&A accounting standards (established in 2003, enforced in 2006)*

1. The classification ~ acquisition
   ~ Unification of interests
2. Accounting method ~ acquisition ~ purchase method
   Unification of interests ~ pooling of interests method
3. Goodwill ~ regular amortization over a period of 20 years
   (or immediate amortization)
4. Negative goodwill ~ regular reversal over a period of 20 years
   (or immediate reversal)

3.2 *Revised M&A accounting standards (established in 2009, will be enforced in 2010)*

1. The classification ~ acquisition
2. Accounting method ~ acquisition ~ purchase method
3. Goodwill ~ regular amortization over a period of 20 years
   The amortized balance becomes the object of impairment (extraordinary loss)
4. Negative goodwill ~ profit within the accounting period
   (extraordinary gain)

The Japanese accounting system was completed with the adoption of the purchase method, as a result of choosing between the purchase method and the pooling of interests method. As an extension of this choice, the fresh start method may be argued for in the future. This was the reason for the revision of commercial law in acknowledgment of the use of the transfer of stocks system.

Transfer of stocks where "a fully joint company is established by all the parent companies" is performed by corporate groups encompassing many types of industry. The IASB introduced the fresh start method into M&A accounting for cases where a joint venture is

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established as a deliberation matter for the future of project summary in April 2002 (Daigo, 2003, p. 143).

In the transfer of stocks where ''a fully joint company is established by all the parent companies,'' the founding parent company has difficulty adopting the purchase method since the company does not become the acquiring entity.

However, in this case, the fresh start method reflects the actual economic situation of the birth of a new company. In other words, the founding parent company is not the acquiring entity; instead, a new company is formed by the transfer of stocks in a process resembling a joint venture, and the target company is the company targeted before the combination. If we think in this way, the fresh start method is reasonable.

Because the new company is recognized as a unified entity, the accounting treatment of the goodwill must be reexamined. The problem is how to understand the *synergy goodwill* reflected in the transfer of stocks of ''the fully joint company established by all the parent companies'' (Daigo, 2003, p. 151).

Synergy goodwill is characterized by the following two traits:

1. The fair value of the going concern element of the target company. It derives from the synergy of the target company's business.
2. Both the prospective net assets generated from the combination of the acquiring entity and the acquired entity and the synergy fairness value of the business.

Point 1 in the above list represents goodwill already present at the time of combination, while point 2 is prospective goodwill generated by the business fusion; these two are collectively called ''core goodwill.'' The core goodwill is generated by the business fusion. Therefore, the birth of core goodwill will be interpreted as the birth of a new company, as long as the business combination produces a synergy effect and it raises the corporate value. This becomes the ground for adopting the fresh start method for the transfer of stocks where ''a fully joint company is established by all the parent companies''(Daigo, 2003, pp. 143–155).

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4 Reexamination of Governance Based on Stockholder Dominance

M&As are on the increase in our country, but there is no particular increase in the number of remarkable M&As, the important thing to note; however, there is no tendency of decrease that has been seen recently. With the increase of M&As, the manager of the target enterprise and its employees sustain great economic impact. Although this point has been understood to some extent, it remains difficult to grasp the degree of influence exerted by all the shareholders together on the acquiring entity and the acquired entity. Controversy rages over whether shareholder value increases or decreases and whether that value is protected or not.

Because it is thought that a manager tends to infringe on shareholder value, the prevailing opinion is that the manager needs monitoring. This role has been fulfilled by an outside monitoring agency, such as a bank, a *keiretsu*, a chief shareholder, a pension fund, or a person who can carry out a hostile buyout. This problem belongs to the economy of M&As.

However, some believe that the shareholder value does not rise if neither the outside monitoring nor the internal monitoring functions. Internal monitoring is a duty fulfilled by the board of directors (Watanabe, Inoue, and Sayama, 2007, pp. 5–9). It is very likely to contribute to the raising of the shareholder value, even if internal monitoring becomes an obligatory task of the board of directors. However, it is also necessary to monitor the stockholders as a group when stewarding the shareholder value.

As a starting point in grasping the issue of corporate governance through accounting, Professor Aishi Imafuku does not regard it as a problem of contracts with the stockholders based on conventional agency, but thinks of the manager of a company as a "fiduciary" officer (Imafuku, 2003, pp. 3–4). Here, the idea that the manager represents and substitutes for the stockholder is abandoned. The reason is that the manager is not concerned with handling contract relations with the stockholders; rather, his main objective is to raise the corporate value of the assets entrusted to him. Today, this viewpoint is becoming generalized.

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The following four problems are relevant when wielding corporate governance through accounting (Imafuku, 2003, p. 5):

1. Accounting in corporate governance is premised on the investors, not the stockholder public.
2. Accounting in corporate governance focuses on the quality of the financial reports, not the validity of the accounting method used to prepare financial reports.
3. The main task of accounting in corporate governance is to make calculations based on the accounting information of the company; the preparation of financial reports is secondary.
4. The study of accounting in corporate governance has its object; the establishment and the establishment mechanism of accounting standards enable the creation of autonomous accounting information within the company.

Regarding the points mentioned above, let us add the following explanations. Point 1 does not refer to a simple investor. The contemporary investor has confidence in the manager's stewardship of funds. Point 2 means that, from the viewpoint of accounting culture, the financial reporting system encourages the reexamination of the quality of positive accounting and conservative accounting. In point 3, the separation of the decision making team from the executive team of the company must be reflected in the organizational structure and the calculation process of the accounting information must be taken into consideration. In brief, point 4 suggests the unification of the organizations that establish accounting standards, in order to unify the accounting model systems reflected in points 1, 2, and 3.

The manager is trusted by the stockholders to make the best use of the company's assets, as well as to raise the corporate value. In this case, in accounting, the corporate value is identified with the total company's assets, and the total assets consist of the total net assets and total liabilities. If we monitor the corporate value based on market evaluation, it is estimated as the current price of the stocks and the market valuation of the liability. However, the corporate value when performing M&As is estimated as the grand total of the asking price of the buyer and the transfer liability (Aomatsu, 2008,

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pp. 29–30). Thus, corporate value can be evaluated in various ways. A corporate value grasped to being common as a base is expectation cash flow namely cash flow brought from an existing business and a future growth opportunity than the past and present cash flow (Hachiya, 2004, p. 154).

In investor relations, investors do not object to taking corporate social responsibility (CSR) as long as the corporate value is controlled by the investors. Therefore, in order to substantially improve the corporate value, a manager must recognize the importance of cash flow management and CSR.

CSR must be central to the activity of a company and it must consider all the stakeholders. If I can call this stakeholder profit, it is necessary to make a clear difference between corporate value, shareholder value, and stakeholder profit. Shareholder value is at the core of this trio; further out lies corporate value and furthest lies stakeholder profit. Shareholder value is central because the company does not exist without the financing provided by the stockholders. In a company that avails itself of financing, corporate activity that considers not only shareholder value but also stakeholder profit becomes essential for the improvement of the corporate value (Aomatsu, pp. 23–26).

5 Conclusion

The accelerating wave of M&As is spreading throughout the world. We are insufficient only by knowing the market or the industry for the complexity whether you lead this to the success. The practical application of highly complicated technical knowledge has become crucial. And technical knowledge must not be employed piecemeal: the most important way to ensure success is to use comprehensive and interdisciplinary knowledge.

However, this comprehensive perspective must also encompass corporate governance, because the practice of M&As should attach great importance to the requirements of not only financial allocation but also of the various parties involved.

Corporate value is changing into a pluralistic phenomenon involving various categories of stakeholders; it is no longer centered

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exclusively on stockholders. By stakeholders, we mean not only creditors and stockholders, but also suppliers, consumers, employees, the community, and stakeholders in the environment. Corporate governance changes with the expansion of the concept of stakeholder. Today, the ideal method of corporate governance takes into consideration capitalist as well as non-capitalist goals and is inherently multi-dimensional. Social value and environmental value are included in the range of corporate purposes, which means what corporate value must be evaluated from a multi-dimensional perspective.

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