ACQUISITION FROM FINANCIAL AND ACCONUTING ASPECT

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Summary

Acquisition as a management instrument of making business has dynamically started to affect the Croatian market. The managers of many private companies have recognized the advantages of a company's external growth and modern management of business combinations. It is a known fact that company acquisition as a strategy demands big and responsible managerial decisions. The author of this article focuses on some of the factors which influence the procedure and the outcome of an acquisition process. Acquisition types and motives, as well as due diligence as the most important part of an acquisition process, have been concisely presented. The presentation of an acquisition undertaking from financial and accounting aspects provides an overview of the relevance of valuation methods, of the application of legal regulations and the necessity of financial reports in making managerial decisions in the acquisition process.

1 Introduction

The globalization process has dynamically and unstoppably spread over Croatian economy and has opened paths to new challenges and confrontations of managements with new market situations. Competition intensification and growth level strengthening, two requirements that are becoming more and more present, characterise a turbulent process of changes. Involvement in market economy trends and adjustment to new conditions has been recognized and they inevitably require the application of new knowledge, specific skills and a new approach to management. Entrepreneurial initiatives of management teams play a dominant role on the global market. Manager's decisions have a vital role for a successful functioning of a company and that is why only the most competent achieve success and survive. Croatian economy faces numerous new economic skills, business combination management being one of them. This paper is going to focus on some segments in acquisition (or takeover) of a company.

The acquisition process itself is neither slow nor simple, having a lot of participants and different interests. It is based on decisions made by managers. The acquisition process takes place in several phases and, because of its complexity, experts from the fields of finances, jurisprudence, book-keeping, as well as other consultants, analysts and appraisers, are almost always included in the process, together with the usual participants. Acquisitions are managerial instruments of creating work and increasing a company value. They require a high level of management skills and a big experience in all elements of a business cycle. Managers often use acquisitions as a mechanism for proving their competence and for achieving better business positions.

However, studies have shown that acquisitions are not always successful because they depend on numerous factors. One of the most important factors of the success of an acquisition is synergy. If there is no synergy, an investment can be meaningless despite a good vision and independency on strategic motives of an acquisition project decision maker. Thus acquisition targets should be chosen carefully and the acquisition process should be well planned and managed by decisions based on set rules. Acquisition is a process which is often limited by unpredictable twists and actions, confronting managers with numerous decisions.

It is a known fact that the first big international acquisitions occurred in the sectors of banking, telecommunications and oil industry, which is completely in line with global trends. For Croatia acquisitions present a new economic category. However, it should be pointed out that in the last couple of years we have had positive experience of implementing external growth strategies in the practice of domestic companies, both in the Republic of Croatia and abroad.

The area of study is focused on the segments of a company acquisition process and on financial and accounting issues as important factors of acquisition project result. Since the subject in this paper is a comprehensive one, an overview of the main guidelines dealing with the application and the importance of the mentioned categories has been created.

The goal or purpose is to look into and analyze the issues of acquisition and takeover procedures, as well as the influence of factors from financing and accounting point of view.

2 Acquisition

In present-day conditions companies survive if they develop and if they permanently build and maintain their competitive position and advantages on the markets where they operate. In such circumstances, companies often decide on an external growth strategy because, unlike internal (organic) growth strategy, it provides bigger chances for a realization of long-term goals in a short time. One of the three ways in which external growth strategy of a company is carried out is ownership integration and it is executed in the form of mergers and acquisitions. A decision on acquisition transaction presents a business undertaking in which a company acquires or buys another company in its entirety or by becoming its majority owner, including it in its business system. In most cases, an acquisition requires large investment capital. In other words, decision on acquisition is at the same time a decision on investment.

"Decision on investment is the most important decision while creating values."[1] Since investment decision results are realized in the future and their benefits are not known with certainty, such decisions carry certain risks. In order for the increased company value to really happen, the management should carefully choose targets and decide on the best combination of investment decisions based on estimates of expected returns and risks and make decisions on how to react if the transaction does not develop the way it had been planned. Such thesis is substantiated by studies claiming that only three out of ten acquisition transactions turn out to be a success.[2]

Croatian financial legislation makes a difference between acquisitions or takeovers of public limited companies[3], for which there has to be a public offering or sale via tenders, and between takeovers of companies which are not listed on capital market and whose takeover does not have to be executed via public offering.

Acquisition can be paid in money or in securities and written contracts have to be made for all agreements.

Acquisition process is often a time-consuming procedure and it is carried out in four[4] phases where each of them includes several activity groups.

2.1. Motives and Factors of Acquisition Procedure

The motives triggering the acquisition procedure process can be numerous and they can be grouped in two groups: internal and external[5]. **Internal** motives would include the following: synergy effects (operative, financial), economy of scale, cost

[1] Van Horne, J.C.: Financijsko upravljanje i politika-Financijski menadžment (Financial Management and Politics – Financial Management), Mate d.o.o. Zagreb, 1997, p. 8

[2] Harding, D., Rovit, S.: Preuzimanje i spajanje poduzeća (Taking Over and Merging Companies), Poslovni dnevnik, Masmedia, Zagreb, 2004, p. 14

[3] According to Securities Market Act, Article 115, paragraph 1 (Official Gazette no. 84/02), Public limited company is a company fulfilling one of the two following conditions: 1) it issues shares by public offering, 2) it has more than 100 shareholders, and its stock capital amounts to at least HRK 30 000 000.00

[4] Howson, P.: Due diligence, Masmedia d.o.o., Zagreb, 2006, p. 12

[5] Majetić, P.: „Stjecanja i spajanja kao način provedbe strategije hrvatskih poduzeća", (Acquisitions and mergers as a method of implementing Croatian companies strategy"), master's thesis, Faculty of Economics and Business, 2004

reduction, increasing returns, improvement of production processes, tax synergy effect, diversification, human resource improvement, intellectual capital and manager ego. **External** motives would include the following: industrial concentration, industry life cycle, globalization processes and macroeconomic environment change.

According to the latest research, company acquisition is explored from five different points of view[6]: financial, process, strategic, human resources management, economic and legislative view. Numerous theories have developed in time explaining why acquisitions of companies occur, what the results of such processes are and how they should be organized in the best way in order for the process to succeed. Human resources management and compatibility of corporative cultures are lately stressed as the most important factors for acquisition success, while market regulation and investment climate are considered to be factors which accelerate, i.e. stop, acquisition processes.

Among most common reasons due to which company acquisitions in international business combinations occur, three most mentioned basic reasons are the following[7]:

1. Consolidation: search for economy of scale
2. Global scope: expansion to foreign markets
3. Acquisition due to competence or new technologies

Three basic factors make prerequisites of acquisition success: a) synergy effect, b) managerial capabilities and c) quality of estimating the value of acquisition target. The efficiency of synergy effects can be manifested on operative and financial levels.

Operative level includes synergy effects of single business function from economy of scale, new technology, new markets, competition limitation, product diversification, tax effects to risk reduction, work specialization and division, better utilization of human resources and other.

Effects of financial synergies can be expected through better borrowing conditions, recapitalization, less risk from bankruptcy, etc.[8]

Managerial abilities are the key factors of a business entity success. That is why management team competence can be a reason for buying a target. In such cases, an acquiring company is interested in acquiring and keeping successful managers

[6] Larson, R., Finkelstein, S.: "Integrating strategic, organizational and human resource perspectives on mergers and acquisitions: a case survey of synergy realisation", Organization 4, 1999

[7] Lassere, P.: "Global strategic management", Macmillan, New York, 2003

[8] Bertoncel, A.: Akvizicije (Acquisitions), Official Gazette, Zagreb, 2006, p. 10

of a target company. Also, substitution of incompetent managers and set-up of new management with new knowledge in a target company can significantly influence the improvement of the company's success.

There are situations which can, for different reasons, influence underestimation of a company, such as: asymmetrical knowledgeableness of a participant, insider information, speculative intentions and other[9]. For a potential customer, insider information presents a gold mine, so if someone has an access to the information which is not available to other people, we are dealing with insiderism.

2.2 Preliminary Activities for Decision Making

In spite of all the advantages that can motivate investors due to future expected acquisition results, the experience so far has, unfortunately, shown that a large number of acquisitions ends up as failures. That is why it should be stressed that companies wishing to execute an acquisition of another company have to be very careful before the decision itself and perform a very detailed analysis which should contain the following[10]:

1. Selection of an adequate target partner. In the case of international acquisitions, search for an adequate partner is somewhat easier, but it includes the existence of numerous other elements that should be taken into consideration.
2. Detailed research of the market position of a potential partner.
3. Trying to define compatibility of the cultures of companies and their management.
4. Defining new structures of an organization after the acquisition.
5. Protection of key resources of a company. One should not allow the resources on the basis of which a target company has built its market position become inaccessible after an acquisition has taken place.
6. Share value estimate. An organization initiating an acquisition has to be sure that its value estimates of a target company will ensure a return of investment. It is the most important step preceding an acquisition.
7. Integration planning. Since an integration process has been implemented, a new way of operating the merged companies should be carefully planned.

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[9] Ibid, p. 12

[10] Sirowel, M. L.: "The synergy trap: How companies lose the acquisition game", Free press, New York, 1997

Acquisitions belong to a group of making business transactions requiring top discipline and self-control in decision-making. “It is not only important how much you know - it is more important to know that there is something that you don’t know”[11]. At the same time, the absolute value is provided by a team who is not focused only on details, but they take an integral overview of operations into consideration. Finally, one should also have a plan of what to do if the business takes a wrong turn.

2.3 Possible Advantages from Executed Acquisition

Possible advantages from an executed acquisition are reflected in the following: increased returns, cost reduction, tax decrease, capital requirement decrease and capital cost decrease.

Increased returns are reflected through marketing profits (improvement of company marketing performances, increase of income and money flows), strategic benefits (potential investment opportunities, management options) and market strength increase.

Cost reduction is reflected in the economy of scale (decrease of unit fixed costs), economy of vertical integration (coordination of interconnected business operations and technological transfer) and utilization of complementary resources.

Tax reduction can be decreased by using accumulated tax loss, unused credit capacity and extra profit funds, by the possibility of increasing depreciation basis and a by the goodwill amortization.

The decrease of capital requirements can be realized by a more efficient method of managing assets (it can be reflected in the following fields: net current funds, fixed assets, research and development and new research) and the possibility of selling unused assets.

Decrease of capital costs can also be realized through economy of scale (issue of securities - relative decrease of issue fixed costs) and portfolio effect (decrease of yield volatility to combined company shares).

2.4 Acquisition Types

Reasons due to which decisions on business combinations, as well as the methods of their implementation, are made, characterise single acquisition types. According to characteristics, the most mentioned are related and non-

[11] Harding, D., Rovit, S.; Preuzimanje i spajanje poduzeć (Taking Over and Merging Ccompanies), Poslovni dnevnik, Masmedia, Zagreb, 2004, p. 27

related acquisitions, friendly and hostile acquisitions and majority and minority acquisitions[12].

Related and Non-related Acquisitions

Acquisitions are classified as related and non-related according to their relative relationship of central activities of companies included in acquisition procedure. Taken generally, related acquisitions can be horizontal or vertical. Horizontal acquisitions refer to an acquisition of two companies within the same industry and production chain – competition acquisition. Vertical acquisitions include companies that are usually in a customer - seller relationship: a producer merges with input supplier or with a dealer of his products. Non-related acquisitions (conglomerate or lateral) are realized between companies of different trades, without special connections between them. One of the most important trends in recent years is the dominance of related international mergers and acquisitions - they make almost 75% of acquisitions.

Friendly and Hostile Acquisitions

Acquisitions can be friendly or hostile, depending on the attitude or recommendation of target company management. If management recommends accepting the offer on company acquisition, then it is considered to be a friendly acquisition. On the other hand, if the management rejects an official offer for a company takeover, it is considered to be a hostile acquisition. International mergers and acquisitions are mostly friendly ones: between 1990 and 1999, almost 95% acquisitions were friendly, according to value and the number of jobs.

Majority and Minority Acquisitions

Majority acquisition is the one in which a company takes over more than 50% of target company shares. It enables the company to effectively merge the acquired company into its own and to have a complete control over it. Minority acquisition is the one in which a company takes over less than 50% of target company shares. Minority acquisitions are characteristic for strategic poolings and partnerships. In the period between 1990 and 1999, 85% of acquisitions were majority ones.

3 Due Diligence

Successful businesses are not created or are seldom created by accident or out of luck. In other words, very concrete tactics and procedures are used in the creation of

[12] Lazibat, T., Baković, T., Lulić, L.: „Međunarodna spajanja i akvizicije u hrvatskoj gospodarskoj praksi“ (International mergers and acquisitions in Croatian economic practice), Ekonomski pregled, 2006

business combinations. The first and the basic fact is to have an investment postulate which justifies a successful acquisition. This implies that decisions are based on a good knowledge of acquisition target. Getting to know the target, i.e. due diligence, is a preliminary phase of an acquisition procedure whose task is to perform a research and an estimate of cost-efficiency and to serve as the basis for substantiating or refuting an investment postulates.

Thus, "due diligence is an examination process on the part of a potential buyer in order to confirm that he is buying what he thinks he is buying."[13]

When two parties find a common interest and start serious negotiations on acquisitions, they make a letter of intent or purchase and sale condition draft as a non-binding document with specified main points around which the agreement has been achieved and which forms the basis for the continuation of negotiations. An investor should build collaborating relationship with the target in order to ensure that the due diligence phase is thorough and productive. Acquisition transaction activities have just begun. Now experts and consultants come into the picture.

Buyer is dealing with an investment from which he expects target benefits and in which he will invest considerable funds. Before the business is concluded, one has to make sure how one understands the operations of a company one plans to buy, whether one will get what one expects and how to carry out the integration. Due to this kind of doubts, a buyer has to execute due diligence from commercial, financial and legal point of view, which will point out the possible risks by indicating the items which should be further negotiated before the final signing of agreement.

Teams of experts, such as auditors, accountants, lawyers and finance specialists, are employed in this process of examination according to inspection areas. Their role is to find weaknesses and their importance, with the purpose of defining a price and estimating prospects for the future. In present conditions in Croatia, banks are those that mostly offer this type of service, although there are other companies who deal with due diligence, such as Confida-Zagreb d.o.o. and others.

Due diligence services are quite expensive. That is why it is possible to carry out the purchase even without due diligence if the business is small in comparison to a purchaser, and if the purchaser is well familiar with the activities of the acquisition target. Due diligence is not legally prescribed, nor is in any other way mandatory but there are numerous reasons of hidden obstacles justifying this expense. A seller is sure to provide information in order to substantiate warranty, but in the case of necessary protection, this will be the only officially available document. Frauds and hidden risks often occur in this type of business. Lawsuits are even more expensive,

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[13] Howson, P.; Due diligence, Masmedia d.o.o., Zagreb, 2006, p. 15

both material- and time-wise, and moreover, they cannot be predicted. However, the ease which customers feel when they have a reliable information on problems before the purchase, and before all, the knowledge offered to customers by due diligence, are the reasons because of which customers most often decide to use this service.

In Croatia, banking companies are most often the ones dealing with due diligence, but there are also companies offering the services of business consulting, auditing and tax consulting.

3.1. Due Diligence Areas and Disciplines

Table 1 Main topics of due diligence [14]

Main topic	Examination area	Required results
Financial	Checking history data, overview of management and the system	Confirm balance sheet items, income statements, cash flows, capital change reports, customer and vendor open accounts, other receivables and liabilities, investments, taxes and stock supervision, assets and small inventory, crediting and loan obligations
Legal	Contracts, personnel documentation, recognizing problems	Guarantees, collaterals and compensations, policies, check-up of all existing agreements, sales contracts, work contracts and applications, lawsuits, payrolls
Commercial	Market dynamics, competitive position of a target company, commercial goals of a target company	Future profit, margin, rebates, development of merged business strategy, input for estimation, strategic customers and vendors

Feasibility studies often consist of a few hundred pages where findings, opinions and suggestions are presented in detail. The better the due diligence, the more customers are familiar with acquisition target, thus also with indirect risks they are taking over. Due diligence enables a customer the following[15]:

- Identification of issues regarding negotiation price thus reducing the risk from big costs
- Risk reduction by identifying items requiring legal protection.

Traditional due diligence reports are created on customer’s request, but recently there are also other types of due diligence, such as seller due diligence, due diligence

[14] Ibid, p. 19
[15] Ibid, p. 15

at public offerings, at purchases from bankruptcy commissioners, as well as at a number of other transactions, especially[16];

- Investments of private investors for the insurance of capital for the development or purchase of a controlling block of shares on the part of the management,
- Giving bank loans before the borrowing or in the case of concern regarding the existing loan,
- Joint ventures,
- Transformation of ownership patterns (public to private, and other).

Sellers usually make due diligence in order to be better prepared for the selling with the purpose of saving management, customers and vendors from a lot of questions, providing arguments that they have given all available information to customers. This enables them to maintain the advantages during negotiations, but for a customer it can present a danger in hidden problems.

The scope and the focus of due diligence depends on the type of business arrangement, i.e. on the area which is the subject of the evaluation. The goal of due diligence report is to provide an insight into risk estimate, the advantages of the whole business deal as a help in negotiations and in achieving values after the transaction has been concluded. [17]

Table 2 Other due diligence disciplines [18]

Main topic	**Examination area**	**Required results**
Human Resources and Culture	Work force structure, employment conditions, responsibility and motivation level, organization	Identifying obligations at employment, estimate of potential costs of human resources and risks during deal making, stress on human resources issues that should be solved during integration, estimation of culture, costs and planning of personnel changes after making a deal
Management	Quality of management, organizational structure	Identification of key issues at integration, overview of a new structure of merged businesses
Pensions	Different pension plans and plan estimates	Decrese of risk from the lack of finances

[16] Ibid, p. 25
[17] Ibid, p. 25
18 Ibid, p. 20

Tax	Existing taxes, liabilities and arrangements	Avoidance of all unpredictable tax liabilities, optimal position of merged businesses
Environment	Obligations emerging from the centre and processes, adjustment with regulations	Potential obligations, nature and cost of actions for the limitation of the obligations
Informatics	Business operations, ownership and technology adequacy	Possibility of system integration; costs connected with it. Plans for the operative effectivness and competitivness
Technology	Business operations, ownership and technology adequacy	Technology threats; maintaining exisiting methods; possibility of improvement; necessary investments
Intellectual property	Validity, duration and protection of patent rights and other intellectual property	Expiry; influence and expenses
Ownership	Documents, land registers, lease agreements	Ownership right holder certificate, asset appraisal and costs
Antitrust	Differently prescribed filling out of the requests – at the state level (what can be expensive if it is not synchronized), market level/ exchange of information with competition	Control of acquisitions and declaration on authority, estimate of antitrust risk due to target company activities, estimation of legal feasibility of the target company contract
Insurance/Risk	Work force structure, employment conditions, responsibility and motivation level. Present, future and, most important, past exposure of business operations, structure and cost of the existing programme	Costs and benefits of risk retention in relation to its transfer

4. Acquisition from Financial Aspect

Another important decision of investing is the decision on financing. Before the final investment decision, financial management has to define the best combination of financing. This implies defining the amount of required funds and making decision on the selection of the financing method. Since for this kind of project big funds are required, from the point of view of the funds management and project risks, the company looks for an optimal source of financing. This will depend on the factors influencing the net present value of the project to be positive, i.e. on the estimation of a situation in which a project makes more return than the return realized on a financial market with the same amount of risk.

A prerequisite for the selection of the best combination of financing is a high-quality analysis of planning and control of company activities, i.e. information on financial operations of the company, as well as confrontation with the estimate of target value and added value for investment. With the purpose of planning necessary capital, the analysis should provide information on expected future profit growth with and without an investment project.

Estimated value of a target augmented for an amount of a defined premium represents the price of a takeover. This amount should be increased by transaction costs for the purpose of defining a total volume of required funds.

Furthermore, created expected future cash flow forms the basis for making decisions on financing and on the selection of financing method. This results from the fact that cash revenues, and not incomes, are the factors of solvency maintenance. A company which does not succeed in maintaining the solvency due to an investment project is sure to be a failure. That is why one of the most important tasks in planning the necessary capital is a good estimation of future cash flows of a project.

The decision on financing can refer to financing with own funds, someone else's funds or these two combined, and it will depend on the capital structure, future cash flows and investment volume. In all three cases, only the estimate of cash flows based on increase can justify an investment transaction.

4.1 Capital Structure

Liabilities side of a balance sheet contains data on the structure from which a company, i.e. company activities, are financed. The main and initial source is subscribed or own capital containing paid shares from founders or from sold shares. The second source are generated reserves and retained profit, and the third category is foreign capital, such as long-term credits or loans, short-term credits or loans, financing on the part of a vendor and accruals, such as taxes and salaries. The fourth source is the issuing of debtor's securities. This is, of course, conditioned by a developed financial capital market. Thus information on capital structure provide the management with the analysis and the ability to make a decision on the method of financing an investment. A company has to know to what extent it is capable of meeting their obligations from own capital and what is the relation between a borrowing or borrowed capital in circulation against the total assets. So a company adjusts liquidity and solvency maintenance according to available own funds and required difference from temporary borrowed sources. From the borrowing point of view, the factor of debt maturity is extremely important, no matter whether we are talking about long-term or short-term debt. It is important that a company finances short-term and temporary or seasonal deviations in liquid funds from short-term borrowings, and long-term deviations from long-term borrowings. Different analysis methods can be used, and the most often used is EBIT (earnings before interest and taxes)/EPS (earnings per share)[19] analysis, i.e. the method of coverage ratio using the following formula:

$$\text{Coverage rate of debt repayment} \quad \frac{\text{EBIT}}{\text{Interest} + \dfrac{\text{Repayment of principal}}{\text{1-rate of taxation}}}$$

The aim is to establish an optimal capital structure that will contribute to the aspiration of maximizing the value of shares or to the increase of value to permanent capital owners.

ASSETS	LIABILITIES
Fixed assets intangible tangible financial Current Stock (material, products, goods) receivables cash Accruals Loss above capital	Equity Reserves Retained profit Loss carried forward Long-term liabilities Short-term liabilities Accruals
Total assets:	Total liabilities:

4.2 Cash Flow

From the financing point of view, short-term liquidity can be disrupted because a company does not manage to settle its immediate liabilities due to unbalanced ratio of cash requirements and liabilities, at the same time having a long-term surplus of free funds. This situation can also be fatal, as in the case of permanent insolvency of a company, which implies a possibility of bankruptcy or even a wind-up of a company. Naturally, it depends on the amount of unsettled obligations, as well as on the inclination of creditors and banks towards a company[20]. That is why it is very important for a company to effectively plan and control liquidity and solvency maintenance, which is achieved by employing skilled and ethical managers.

[19] Van Horne, J.C.: Financijsko upravljanje i politika-Financijski menedžment (Financial management and politics – Financial Management), Mate d.o.o., Zagreb, 1997, p. 317

[20] I had the opportunity of experiencing a situation in one company having all the necessary conditions for doing business, from high-quality asset structure to high-quality line of production with international demand, and which ended in bankruptcy and was closed, firing over five hundred skilled workers because it was on mortgage for debts to a bank from unethically associated companies.

The main goal of cash flows is to establish date balance between cash revenue and cash expenditure because of cash requirements which will help realize company's solvency, liquidity and profitability. The methods of cash flow adjustments at the level of short-term and long-term changes of assets and capital are used for achieving this goal.

The expected net cash flow of a project is the difference of cash revenue and expenditure by periods during investment duration and it is at the same time relevant information for making a decision on acceptability or unacceptability of the project. Unquestionable importance of a cash flow from business activities indicates that, seen from a long-term perspective, a company has to generate positive cash flows from business activities if it wishes to survive. Negative cash flow from business activities is a sign for creditors and investors that a company is not capable of paying its liabilities, interests and dividends promptly, and they will thus hesitate whether to invest in such u company or give loans. In other words, a company then also loses other sources of financing from which it was able to generate positive cash flows and can thus lose money and become insolvent.

	Initial cost	1st[t] year	2nd year	3rd year	4th year	5th year	6th year
Cash revenue		180 000	360 000	480 000	540 000	330 000	150 000
Cash expenditure	450 000	120 000	210 000	300 000	300 000	210 000	120 000
Net cash flow	-450 000	60 000	150 000	180 000	240 000	120 000	30 000

4.3 Company Valuation

The focus of acquisition process interest is the value of a company-target. It represents the present value of future (expected) benefits[21] and the most important vital factor, both for the company which takes over and for the one which sells. The market differentiates between several terms for value, and the most often used are inner value, market value and synergy value.[22] Inner value is defined by analysis of a company and by calculation of net present value of cash flows for a company having existing management, plans of growth and income. Market value is determined by the supply and demand market of interested entities and it is almost always higher than inner value because it contains market premium reflecting market expectations, especially with joint stock companies. Synergy value is not measured easily because it is based on the specifics of expected effects which an investor predicts with the purpose of organization improvement, capital structure change, competition elimination, deviations in risk assessment and other. Takeover premium is most often paid

[21] Bertoncel, A.: Akvizicije (Acquisitions), Official Gazette, Zagreb, 2006

[22] Ibid, p. 48.

to targets that are quoted on capital market and are generally defined in correlation with expected synergy effects.

The most often used scientific methods for the company valuation are the following:

- mean rate of return method
- internal rate of return method and
- net present value method.[23]

In each of the methods the key issue is the period of return, realistic assessment of expected growth and the risk that the expected income will not be realized.

Mean rate of return method is the simplest one and is based on the calculation of the ratio of average annual profit after taxation and the investment for a specific period. If a calculation determines that mean rate of return is higher then the required return rate, the project is acceptable.

Internal rate of return and present value methods are considered to be acceptable methods because they are based on discounted cash flows as a more effective indicator.

Net present value method is applied for the calculation of required capital so that all cash flows in economic duration period are discounted to the present value by using the required rate of return. By calculation which uses this method, the result is the sum of discounted cash flows ≥ 0, the project is acceptable, and vice versa, it is not acceptable. In other words, the return is the same as the invested one or higher - the project is acceptable. This method determines a net present value of invested capital, and not rates.

The calculation is done according to the following formula:

$$NSV = \sum_{t=o}^{n} \frac{A_t}{(1 + k)^t}$$

Internal profitability rate method is actually a calculation by internal rate method in which net revenues by years and the total for project duration are taken into consideration, and they are then discounted by different discount rates in order to obtain the rate of return. This means that it is necessary to find a discount rate with which net revenues from economic project flow are reduced to zero, thus determining the profitability of a project. Since this is a very complex procedure, the calcula-

[23] Van Horne, J.C.: Financijsko upravljanje i politika-Financijski menedžment (Financial management and politics – Financial Management), Mate d.o.o., Zagreb, 1997, p. 143

tion interpolation method is used. The criterion taken into consideration in deciding whether to accept or reject a project is a comparison of internal rate of return with the requested limit or minimal rate of return. If internal rate of return is higher than the requested one, the project is accepted, and vice versa. This is of a special interest for joint stock companies because possible market price of shares can be tracked and supervised in this way.

After all relevant analysis, estimations and calculations have been defined, financial management makes a decision on the acquisition financing method. „An ideal purchase target with borrowing represents a company which:

- operates with stability,
- does not have too large a growth,
- makes a good positive cash flow and
- is not in debt."[24]

5 Acquisition from Accounting Aspect

Accounting is an inevitable business segment, both from legislation and business reporting aspects. Information that management requires for decision making are concentrated in the accounting. Everybody controls their funds and measures their successes and they use accounting information as the basis. Business transactions are recorded in line with accounting profession, based on special accounting techniques. Special importance is reflected in expressing business success and reporting on asset and capital position and on the way the asset is used with the purpose of increasing the value for owners. Acquisition accounting is especially complex subject handled by International Financial Reporting Standards, as a help in accounting definition of recording method of a transaction and in financial report creation.

5.1 Accounting Records

As it has already been mentioned, an acquisition is a takeover of a company, whether complete or partial, mostly of majority shares. The reason for taking over majority shares is because acquiring company's goal is to get a controlling block of shares which would enable a control over acquired company. The acquired company will not change its legal status in the process - it will operate with total assets, employees and all rights and liabilities they had so far. Transactions will not be recorded nor will accounting reports be changed in the acquired company. The change is only reflected in the owner of shares or stocks. However, the changes will be recorded in

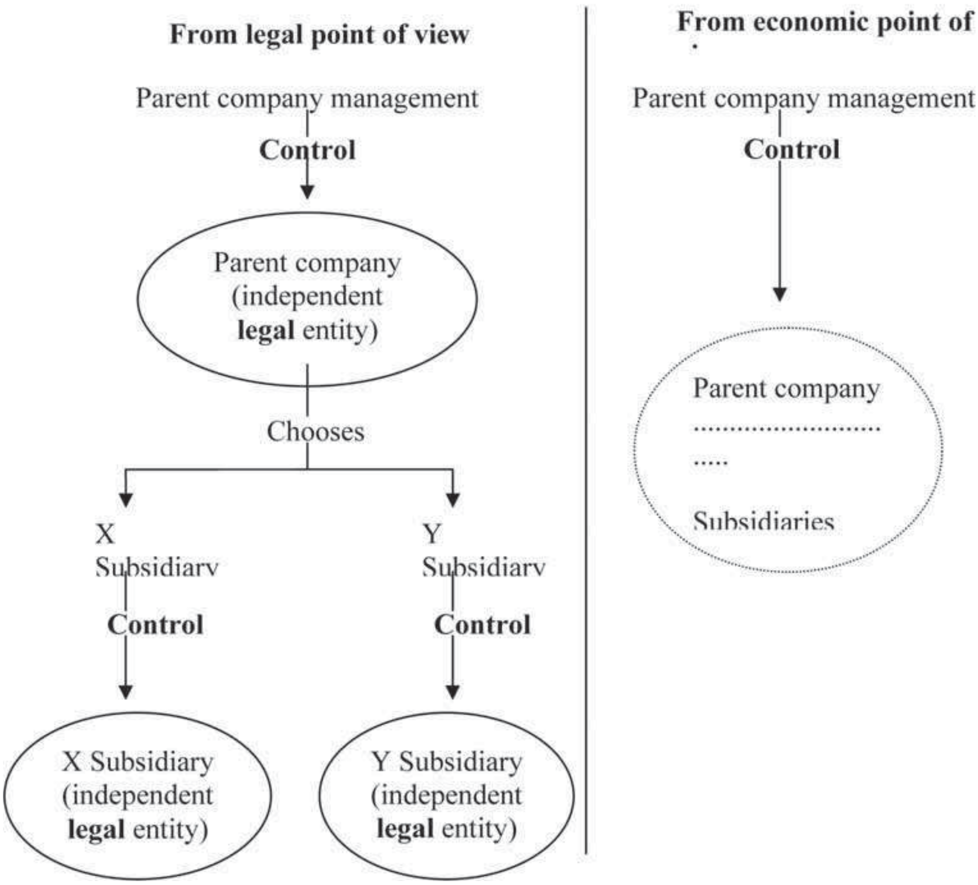
[24] Bertoncel, A.: Akvizicije (Acquisitions), Official Gazette, Zagreb, 2006, p. 73

the accounting of a company which takes over. If the purchase has been financed by own funds, the value of long-term investment will be increased and financial funds will be decreased on asset accounts. When a purchase has been realized by the financing from other sources, be it from received credits from banks or other entities, or from issued debt securities, instead of financial asset reduction, the liabilities will be recorded on liabilities accounts, i.e. on capital source accounts. But this is not as simple as it may sound.

Accounting records are special techniques of recording transactions which are legally prescribed, and in Croatia that would be Accounting Act[25], Croatian Financial Reporting Standards (hereinafter: HSFI) and International Financial Reporting Standards (IFRS), applied in big companies and companies according to other financial regulations. Specific qualities of records are important because of information on which financial reports are based, and which have to be reliable and comparative with other different companies.

A company which acquires all or most of the shares or ordinary stocks in another company is called a parent company, and acquired company becomes a subsidiary. Majority share implies more than 50%. In this situation a parent company has the right to choose the management in a subsidiary and in that way to control its funds and business, and the subsidiary becomes a controlled subject, i.e. associated company. In that way these two companies (two legal entities) become one economic entity.

[25] Official Gazette no. 109/2007, Zagreb.



Source: Meigs&Meigs: Računovodstvo: Temelj poslovnog odlučivanja, (Accounting: Basis of Business Decision Making), Mate d.o.o., Zagreb, p. 801

Accounting records of an acquisition, i.e. records during entering into a business acquisition of another business entity, are executed in line with IFRS 3 respecting specific situations from IAS 18, 27, 37, 38 and 39 in parent company accounting. Business acquisition is calculated by the method of a purchase from the perspective of an acquirer who acquires control over another merging company. The usage of the purchase method requires activities according to the following steps:

a) Identification of acquiring company,

b) Measurement of costs of business merger, and

c) Distribution, on acquisition date, of cost of a business merger to purchased assets and assumed liabilities and contingencies[26].

Purchase method according to IFRS 3, clause 24 to 65 defines:

a) **Acquisition cost** is calculated as a sum of fair value on the date of trade, given assets and assumed commitments and capital stock instruments issued by a company which acquires in exchange for the control over acquired entity and all costs which can be directly connected with business combination, such as acquisition registration, expenses for lawyer, accountant, appraiser and consultant and other direct costs of an actual acquisition,

b) on the acquisition date, a company which acquires allocates the costs of a business merger acknowledging recognizable assets, commitments and contingencies of an entity who acquires by their fair values, apart from assets classified for sales (IFRS 5),

c) each difference between acquisition cost and fair value of acquired recognizable asset and liabilities and unpredicted commitments is calculated and recorded on assets as goodwill.[27] In other words, this is the difference between the payment on the part of a company which acquires and acknowledgment of acquirer's identifiable assets, liabilities and contingencies.

Goodwill can be positive or negative. If it is positive, i.e. if there is a residual cost of a business acquisition, the goodwill is not amortized but written off as expenditure from asset impairment in line with IAS 36, *Impairment of Assets.* If goodwill is negative, which can result from a cost lower than net fair value of acquired asset of acquired company, thus presenting a bargain offer, than the quality of assets and liabilities appraisal procedure is considered first. If it remains negative, goodwill is written off into incomes.

If acquisition is carried out in phases through several transactions, such as for e.g. when shares are bought, then each transaction is considered separately on the part of an acquirer and the expressed recording method is executed on the date of each transaction separately, and the amount of goodwill is defined for each transaction. The reason for this is that fair value of assets, liabilities and contingencies can differ on a day for each transaction. These values have to be recognized on the part of acquirer, which also implies the recognition of goodwill value differences.

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[26] Međunarodnis standardi financijskog izvještavanja (Službeni tekstovi za Hrvatsku) (International Financial Reporting Standards, official texts for Croatia), RriF Plus, Zagreb, 2007, p.76
[27] Ibid, parag. 51 – 57 IFRS 3

If acquisition can be determined and recorded only on a temporary basis because fair value of identifiable assets, liabilities and contingencies of acquired entity can be identified only temporary, then acquirer uses only temporary values. An acquirer has to acknowledge a harmonization of temporary values as a completion of initial calculation within 12 months from the acquisition day. The harmonization of initial postings upon initial calculation completion has to be acknowledged only as error correction in line with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors.* Change impact is recognized in line with IAS 8 in the same or in future periods. Due to comparative information effect, error correction is posted retrospectively and in repeated financial reports it shows a situation as if there were no errors at all.

The importance of accounting records is reflected in financial reporting because financial reports actually represent a sum of information on occurring business transactions in a period.

5.2 Financial Reports

Acquirers investing in acquiring a company have to publish information enabling financial report users to appraise the nature and the effect of a business acquisition.[28]

Financial reports are information on a financial balance and the business success of a business entity, i.e. an image of profitability and financial position of a company and as such represent the basis for decision making. The management makes responsible business decisions. Investors, bankers, customers and vendors decide whose share to buy, to whom to give loans, to whom to sell goods, whose goods and/or services to buy. The Government controls from which companies to collect tax and other incomes. They are all users of financial reports and they all find their interest in publishing financial reports.

The most often used financial reports are Balance Sheet, Income Statement and Cash Flow. The data from a balance sheet are analyzed and used for numerous information - for determining capital structure and required cash funds, among others. Assets structure offers information on assets, and liabilities structure provides information on capital and liabilities. Users would like to know what is the structure of company capital source, whether it is or not in excessive debts, whether it pays dividends, what is the structure of assets, what is the turnover of assets from which revenue is created, how debts are returned and liabilities settled. Income statement offers information on how a company generates income, from primary line of busi-

[28] Ibid, parag. 66

ness, financial or investment activities or other activities, what is the profit, etc. Cash flow is a report from which users obtain information on how a company uses cash funds, whether there is a danger of insolvency and from which activities is net cash flow generated.

A large amount of funds is invested in company acquisition investments and that is why shareholders, but also other users, prefer more information on each executed acquisition in order to be able to estimate the nature and effect of the project. IFRS 3 prescribes which information should be published by acquirer for the needs of financial report users. These are detailed single data and activities undertaken and realized in acquisition procedure such as:

- names and descriptions of the combining or businesses,
- acquisition date,
- percentage of voting equity instruments acquired,
- acquisition cost,
- if equity instruments are issued, one should specify a number, fair value and how fair values were determined,
- amounts recognized at the acquisition date for each class of acquirer's assets, liabilities and contingent liabilities,
- amounts of profit and loss of acquired company which are included in acquirer's profit or loss,
- details about the factors that contributed to recognition of goodwill
- information connected with error corrections,
- detailed information on all amounts and activities in relation to goodwill amount
- detailed descriptions on exchange rate differences and goodwill decrease effects,

and all other information contributing to meeting the needs of objective information goals.

Management is responsible for fulfilling financial reporting obligation.

5.2.1 Consolidated Financial Reports

Since a parent company and its subsidiaries are separate legal entities, financial reports are prepared for each of them separately. In financial reports of a parent company subsidiaries are classified as long-term investments. Since associated companies function as a unique economic entity, parent company prepares consolidated financial reports in which financial position and business results of the whole group are displayed as one business entity. Investors are very interested in consolidated financial reports and they are a part of annual financial reports which a parent company submits to their shareholders or owners.

An important fact for a consolidated report is that assets, liabilities, revenues and expenditures of two or more separate legal entities are unified in a unique package of financial reports. However, transactions between associated companies are just internal transactions so they should not appear in consolidated financial reports. In order for associated company transaction effects to be eliminated, because there are no accounting records at the level of a group, one should create work notes in which all items referring to intracompany transactions are expressed. Three groups of elimination items occur in these notes:

a) Intercompany shares

b) Intercompany debts

c) Intercompany revenues and expenses.

After intercompany positions are separated, balance sheet, income statement and cash flow are created in the total amount for all companies of the group. An example of a balance sheet before and after acquisition is shown below.

Example 1

A large company purchases a small one for HRK 100 000, assuming all small company's obligations. Cash balance and goodwill amount should be established in a consolidated balance sheet. We can presuppose that the large company plans to finance the acquisition in cash in the amount of HRK 10 000 and by a loan debt in the amount of HRK 90 000 (long-term loan).

Balance sheet before acquisition			
	HRK Large	HRK Small	HRK Small (FMV)
Cash	20 000.00	3 000.00	3 000.00
Stock	40 000.00	10 000.00	15 000.00
Receivables	20 000.00	8 000.00	8 000.00
CURRENT ASSETS	80 000.00	21 000.00	26 000.00
Immovables, plants and equipment	120 000.00	50 000.00	60 000.00
Goodwill	-	-	-
TOTAL ASSETS	200 000.00	71 000.00	86 000.00

Liabilities toward vendors	22 000.00	10 000.00	10 000.00
Calculated liabilities	3 000.00	1 000.00	1 000.00
SHORT-TERM LIABILITIES	25 000.00	11 000.00	11 000.00
LONG-TERM LIABILITIES	25 000.00	10 000.00	10 000.00
Ordinary shares	10 000.00	1 000.00	
Paid capital	40 000.00	9 000.00	
Retained earnings	100 000.00	40 000.00	65 000.00
TOTAL OWN CAPITAL	150 000.00	50 000.00	
TOTAL	200 000.00	71 000.00	86 000.00
Ordinary shares			
Nominal value	10	2	
Market value	80	8	

Balance sheet after acquisition (purchase method)

	HRK Large	HRK Small	HRK Small (FMV)
Cash	10 000.00	3 000.00	3 000.00
Stock	40 000.00	10 000.00	15 000.00
Receivables	20 000.00	8 000.00	8 000.00
CURRENT ASSETS	80 000.00	21 000.00	26 000.00
Investment in subsidiary	100 000.00		
Immovables, plants and equipment	120 000.00	50 000.00	60 000.00
Goodwill	-	-	-
TOTAL ASSETS	290 000.00	71 000.00	86 000.00
Liabilities toward vendors	22 000.00	10 000.00	10 000.00

Calculated liabilities	3 000.00	1 000.00	1 000.00
SHORT-TERM LIABILITIES	25 000.00	11 000.00	11 000.00
LONG-TERM LIABILITIES	115 000.00	10 000.00	10 000.00
Ordinary shares	10 000.00	1 000.00	
Paid capital	40 000.00	9 000.00	
Retained earnings	100 000.00	40 000.00	65 000.00
TOTAL OWN CAPITAL	150 000.00	50 000.00	
TOTAL	290 000.00	71 000.00	86 000.00
Ordinary shares			
Nominal value	10	2	
Market value	80	8	

6 Conclusion

In Croatian economic environment, acquisition as a business combination is the topic of the new age. Also, it implies a very complex area of economic importance and can be elaborated through numerous topics. Our purpose was to cover some of the characteristics of acquisition process and the influence of financial and accounting area on managerial decisions.

New economy is based on knowledge and competition, it enables large companies and corporations to collect financial funds from several sources - internally, through the issuing of own capital, and externally, through the systems of banks and other financial institutions. This gives them the advantage over small companies which are not so strong financially.

Acquisition transactions are almost always connected with investments of large funds which can return in the future and are not without risks. That is why manager's decisions are liable to numerous check-ups before a final decision is made. Acquisition process is carried out in several phases and it implies a good knowledge of the target. Detailed analysis and multiple assessments, from assets to employees, business conditions and possible benefits, represent a prerequisite for making a final decision.

Due diligence services are one part of the process which is considered to be the most influential one for an acquisition effectiveness. These services demand a high level of expertise, professionalism and responsibility and are often very expensive. That is why smaller investors, especially those who know the acquisition target, avoid using external due diligence services. Of course, this can be counterproductive due to possible traps which can be revealed if this service is missing and when it is already too late for investors.

Experts and consultants, people who know the effects of acquisitions, often criticise acquisitions saying that customers are those who lose the most because they are often prepared to pay a bigger price than the market price. The explanation is that, on one part, offering party demands unreasonably high prices in relation to actual market value, and on the other hand, they blame the irrationality of top managers which is reflected in "behind-the-scenes conflicts between individual and group egos who do not want to lose, even if their parent companies are brought to the verge of indebtedness"[29].

However, acquisition are trendy, they are carried out with a strong dynamics and have an important influence on economic development. Rational approach, unomittable synergy and consistency can results in strategic goals.

The importance of accounting records and reports is irreplaceable for any company. Business activities of each business entity start and finish with accounting records and reports. Acquisition procedure also starts with recordings in accounting documents and reports, analysis and planning are based on them and managers' decisions are made on the basis of those documents. The main strength of accounting information lies in the reliability of written information and in the objectivity of the measuring of written changes. Accounting is a specific language of business and a special skill of interpretation, measuring and connecting results of economic activities. Expressions such are assets, capital, liabilities, net profit, cash flow, earnings by share are just some of the examples of technical accounting expressions used in the business world. „Each investor, manager and decision maker has to understand accounting expressions and terms clearly if he wants to participate and successfully communicate in a business community"[30].

Techniques and methods of accounting records, calculations and reporting differ from country to country. This is actually one of the weaknesses for the management of multinational companies and these differences should be overcome. Especially

[29] Jurković, R.: Plaćam više i po cijenu vlastite propasti (I pay more, even if it ruins me), www.svan-consulting.com

[30] Meigs & Meigs: Računovodstvo temelj poslovnog odlučivanja (Accounting Basis of Business Decision Making), Mate d.o.o., Zagreb, 1999, p. 4

because of managerial decision making based on financial reports, and also because of the creation of consolidated financial reports in a parent international company. Accounting Act and International Financial Reporting Standards (IFRS) are applied in Croatia, together with other legal regulations from the tax system and other regulations.

Acquisition transactions for Croatian accounting practice present a topic of new economy, and are quite complex due to the lack of clarity of International Financial Reporting Standards or International Accounting Standards.

Acquisition accounting can be viewed from the investor's point of view and from acquired company's point of view as well. From the point of view of investors, the accounting uses the methods of IFRS/IAS 3, 27, 31, 32 and 39 in line with the percentage of participation in ownership, with the difference between the purchase of a share or of ownership instruments. The study of these standards brings us to a conclusion that they are quite complex and unclear.

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