

Effects of business combinations on the competitive environment

Moiescu Florentina, University "Dunarea de Jos" of Galati

florym2003@yahoo.com

Golomoz Ana-Maria, University "Dunarea de Jos" of Galati

golomoz_ana@yahoo.com

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Abstract

This paper deals with the results of the businesses combinations and the advantages felt in solving the problems of certain entities, the extension on other markets or obtaining increased quotas on the market. Also, businesses combinations can generate disadvantages regarding the access to credits or negative effects on the salary. A business combination is based on taking risks and has advantages as well as disadvantages, on both the short and the long term, while the decision of making it has in view the development strategy of the organisation. The aim of the paper is to analyze and balance the benefits and disadvantages of business combinations. It is questioned the need to use this method and its use only for the advantages obtained despite the existing disadvantages.

1. Introduction

The economic progress, the competitive environment, the economic and financial problems determine the entities to identify the best solutions in order to cope with conditions, often difficult, in which they unfold their activity. Among the strategies to which the managers often resort, having effect the development of the entity they manage or at least its survival on the dynamic market, is the restructuring strategy, an important part of these being represented by the entities combinations.

International financial reporting standards use the term of the business combination, which is defined as being a merger of separate entities into a single enterprise reporting (Iasplus 2017). The accounting treatment of business combinations from the perspective of the international financial reporting standards was an issue much debated, polemics continuing even after the changes made in the content of the IFRS 3 "Business Combinations" (elimination of the method of interests pooling). Even if the acquisition method remained the only recognized method by international standards, its practical application has undergone changes over time, focusing on the identification and evaluation of assets, liabilities, contingent liabilities, goodwill, the subsequent treatment of these elements and information that are required to be presented in the financial statements.

Another important issue that creates accounting controversy is resorting to the depreciation of the value of goodwill, as a result of the completion of the test of compliance with the standard IAS 36 Impairment of assets. Some entities might be tempted to use the goodwill as a tool of "embellishing" the image of the performance, they impairing the asset in question whenever it would be in the advantage of the management or would improve the image towards third parties. As a result, systematic amortization has the advantage of a not being practiced in relationship with the size of the performance of the buyer (Raffournier, 2005, p.476).

According to IFRS 3 a business combination represents the grouping of several separate entities in a single reporting entity (Iasplus 2017). The following transactions meet the definition of a group of entities:

- the acquisition of all the assets and liabilities of an entity
- the acquisition of assets, liabilities and rights to the activities of an entity that meet the definition of a business
- the establishment of a new legal entity which will take over the assets, liabilities and business of the grouped entities

A business combination may be structured in different ways for legal, tax or other reasons. The transaction can take place between an entity and the shareholders of the other or between shareholders of the resulted entity. The counterparty can be represented by the actions of the buyer, money or other assets, taking over debts (Grigori, 2013, p.158).

It can be inferred from here that in the scope of action of IFRS 3 enters the merger by absorption, merger by acquisition, partial contribution of assets under certain conditions. All business combinations entering into the scope of action of IFRS 3 are managed according to the acquisition method.

A transaction may be accounted for according to IFRS 3 if the purchased items meet the definition of a business. A business is an integrated set of assets and activities managed to ensure a gain, lower costs or other economic benefits to the participants.

In the scope of this standard, the following do not enter (Iasplus 2017):

- business combinations in which individual enterprises or entities are brought together in order to form joint ventures;
- business combinations between entities or businesses under common control;
- business combinations which comprise two or more mutual entities;

- business combinations in which the entities or individual businesses are grouped into one reporting entity only on the basis of a contract, without obtaining equity interest.

An entity may apply IFRS 3 to manage groups excluded from the sphere of action of the standard or to use another policy following the provisions of the IAS 8.

The competition is one of the most important factors that affect the competitive strategies of organisations. In order to develop strategies, we must analyze both the existing competition on the market, and the new companies entering the market. Strategies need to be adjusted permanently taking into account the dynamics of the competition as the competition changes its strategies according to market trends and requirements. Organizations need to plan their strategies taking into account possible reactions from the competition, such as business combinations that would change considerably dynamics of the market and of the competitive environment (Markgraf, 2017).

A business combination often means obtaining a larger share of the market, which, in many cases, puts the competition in a weaker position by obtaining a dominant position on the market. Groups of businesses can lead to obtaining economies of scale, which means lower unit costs, resulting in greater profits (Wiley, 2012).

A business combination, in order to be profitable, must abide by the following three rules (Gomes-Casseres, 2015):

- 1) Grouping of the competition on the market, the existence of entry barriers on the market, obtaining an important share which would represent a monopoly, the existence of similar products, the innovation within a certain market, as well as whether the benefits of combination overpass the negative impact on competition (Mehta, 2012, p.97) must have the potential to create more value than each separate business would create.

- 2) The grouping must be structured and conducted in a correct manner to create the desired value, and to achieve the proposed objectives.
- 3) The profit made by each entity of the group must motivate the parties to participate in the business and to achieve the objectives.

In order to establish whether a business combination would affect competition, different factors are taken into account such as the level of competition on the market, existence of entry barriers on the market, obtaining an important share which would represent a monopoly, the existence of similar products, the innovation within a certain market, as well as whether the benefits of combining overpass the negative impact on competition (Mehta, 2012, p.97).

The purpose of this paper is to analyze and compare the advantages and disadvantages of business combinations, the impact of the combination on the acquiring entity and if this method is required or is used for the advantages obtained, in spite of the existing disadvantages.

2. Managing business combinations by acquisition method

Managing business combinations, which fall within the scope of the standard IFRS 3, is carried out on the basis of the acquisition method and the use of fair value. All business combinations, except in rare cases of international standard exclusion from the field of use, must be handled according to the acquisition method (Iasplus 2017).

IFRS 3 standard prohibits the method of pooling interests for both the combinations which enter into its field of application, as well as for groupings between mutual entities and those based on the single contract, without making financial stakes (Feleagă & Feleagă, 2006, p.54). The acquisition method is applied and in the case of true mergers or mergers of equals.

The acquisition method is at the basis of managing to take control through partial provision of assets or mergers since the operation affects one or more activities, such as those defined by the IFRS 3 standard, and the method is not specifically excluded from its scope of application.

The acquisition method involves the following stages:

1. Identifying the buyer;
2. Determining the cost of the group;
3. The allocation of the cost of the group between the assets and liabilities acquired (including contingent liabilities) at the date of the group.

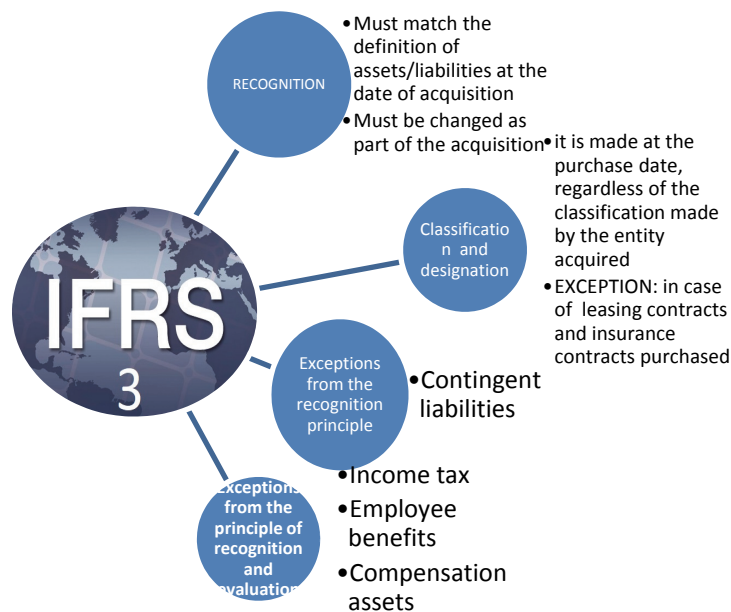


Figure 1: Recognizing assets / liabilities in a business combination

The assets disposed and liabilities undertaken by the buyer are assessed at fair value. If the transaction is carried out through the issue of shares, they are assessed at the market price at the date of exchange. The acquirer assesses the acquired identifiable assets and liabilities assumed at their fair values at the date of acquisition, as shown in figure 2.

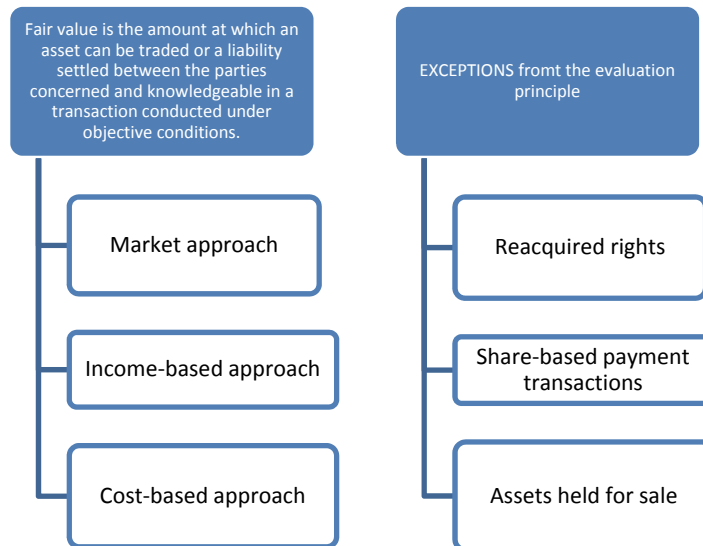


Figure 2. Assessing at fair value in a business combination

Direct costs related to acquisition include fees paid to accountants, assessors, legal advisors. Administrative costs and other costs that have no direct connection with the acquisition are period costs. The costs of issue of shares are accounted for according to IAS 32 (they are deducted from shareholders' equity), and the costs related to the issuance of debt instruments affects the value of the debt (according to IAS 29).

The contractual provisions, in specific situations, suppose an additional counterperformance based on certain subsequent events. Its value influences the cost of acquisition at the date of the combination if it is likely to be supported and if it can be assessed reliably and requires recognition of a liability assessed at fair value for the contingent counterperformance. If subsequent events no longer exist, or the value of the counterperformance is amended, the purchase cost will be adjusted.

The allocation of the acquisition cost of the acquired assets and liabilities. The buyer will allocate, at the acquisition date, the cost of the combination over the fair values of assets, liabilities and identifiable contingent liabilities. Exception to the rule of the evaluation at fair value, are the assets owned in view of transfer under IFRS 5.

The elements that require to be accounted for separately from goodwill are assets, debts and liabilities, if any, of the acquired company that meet certain conditions. The general conditions for the identification of assets and liabilities of the acquired company are (Iasplus 2017):

- (i) it is probably that future economic benefits relating to the asset to provide benefits to the buyer or the latter should pay the outflows of resources required for obligations settlement;
- (ii) there is a reliable assessment of fair value. In case of an intangible asset or of any liability, only the condition of reliable assessment of fair value must be fulfilled.

The buying entity shall recognize in the moment of the combination a contingent liability of the bought entity if its fair value can be determined reliably. After initial recognition, the buyer will assess the contingent liability to the maximum between the amount that would be recognised in accordance with IAS 37 and the amount initially recognised, less cumulative amortisation recognised according to the IAS 18.

IFRS 3 prohibits the buyer to recognize at the date of the grouping a debt for future losses and other costs estimated to be incurred. A restructuring plan of the purchased company conditioned by the grouping is not, before grouping, an obligation of the purchased entity and neither its contingent liability.

There is a period of one year during which the assets and liabilities recognised at the acquisition date can be derecognised on the basis of information relating to the circumstances existing at the time of purchase. Any adjustments affect the goodwill.

3. The recognition and assessment of goodwill in a combination of enterprises

According to IFRS 3, goodwill is defined as being "the unidentifiable part of the payment made by the buyer with the occasion of a cluster of enterprises" (Feleaga & Feleaga, 2006, p.54). Goodwill is included in the consolidated balance sheet at an amount equal to

the difference between the acquisition cost and the share belongs to the acquirer in the fair value of assets, liabilities and future identifiable acquired liabilities (Charles, Stanley & Clark, 2004).

The international body of normalization (IASB) considers that the goodwill is indicated to be stated fully at assets as it is constituted, mainly, from the nucleus of the goodwill, and its recognition as asset is recommended than its accounting as expenditures (Yuan, Herve & Jacques, 2007).

According to the Romanian legislation, O.M.F.P. no. 1802/2014 specifies that goodwill "recognized in a business combination is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and recognised separately"(NAFA, 2014, p.31).

In the case of a business combination, the buyer who purchases the assets, takes over the goodwill created by the salesman internally which can be defined as supervalue which helps and influences the development of a profitable business. However, IAS 38 "intangible assets" prohibits the recognition of goodwill created internally.

Goodwill is distinguished from intangible assets by the fact that the latter may be transferred, sold, changed, rented in exchange for future economic benefits which can be distributed, but without affecting the other assets of the same activity.

Positive goodwill occurs as a result of a positive difference between the two, but a negative difference leads to a negative goodwill.

Goodwill does not create cash flows independently from other assets or groups of assets, but contributes to generating cash flows through its allocation to each cash generating unit of the buyer, from the date of the purchase. After initial recognition, the purchaser shall evaluate the goodwill as a cost of which the losses from cumulative write-downs are deducted. After the initial accounting, according to IFRS 3, the positive goodwill is not depreciated. However, it is subject of an impairment test before the end of the acquisition

exercise and subsequently annual tests or more frequent, in case there are clues regarding the loss of value. IAS 36, 'Impairment of assets', stipulates that the loss associated with the depreciation is the positive result of the difference between the carrying amount and the recoverable amount. The recoverable amount is regarded as the minimum between the net fair value and value in use (Mititelu, Caraconcea & Dinu, 2014, p.5).

4. Determining the acquisition cost of an entity

In order to illustrate the calculation of the acquisition cost, we assume that the company X purchased 75% of the shares of firm Y at a cost of 60,000 u.m. At the date of acquisition, the balance sheet of the companies X and Y, is as follows:

Elements	Company X	Company Y -historical values-	Company Y -fair values-
Intangible assets	10.800	15.200	29.200
Tangible assets	20.000	7.400	7.000
Other fixed assets	100.000	4.000	3.800
Stocks	-	33.000	27.800
Claims commercial	10.000	30.000	30.000
Receivables deferred tax	-	-	2.800
Available	18.000	10.000	10.000
TOTAL ASSETS	158.800	99.600	110.600
Equity	80.000	58.000	64.000
Provisions for risks and charges	18.800	1.000	6.600
Debt deferred tax	-	600	-
Other liabilities	60.000	40.000	40.000
TOTAL EQUITY	158.800	99.600	110.600

For this acquisition, the Company X had the following expenses:

Fees for auditing financial situations of the Company Y- 8.250 u.m.

Legal fees for acquisition – 7.500 u.m.

Fees for strategic advisors – 10.000 u.m.

The acquisition cost of the company Y:

Element	Value (u.m.)
The acquisition price	60.000
The fee for the auditor	8.250
Legal fees	7.500
Fees for strategic advisors	10.000
TOTAL	85.750

At the date of acquisition, the buyer will allocate the cost of the group over the fair values of assets, liabilities and contingent liabilities. IFRS 3 prohibits the buyer to recognize at the date of the grouping a debt for future losses and other costs estimated to be incurred. As a result, the net accounting asset at the acquisition date, assessed at fair value, is:

Total value of assets	110.600
- Provisions for risks and charges	6.600
- Other liabilities	40.000
	<hr/>
	64.000

The accounting treatment of the difference resulting from the acquisition

Goodwill is determined as the difference between the acquisition cost of securities and the share that belongs to the purchaser in the fair value of assets, debts and liabilities eventually purchased, as thus:

Company X paid 85.750 u.m. to get 75% of the net accounting asset of the company Y, which is : $75\% \times 64.000 = 48.000$ u.m. The difference between the acquisition cost and the share in the fair value of net asset value of the company Y ($85.750 - 75\% \times 64.000 = 37.750$ u.m.) represents a goodwill and is registered in the asset consolidated balance sheet of the group X.

The part of the mother-company is eliminated in counterparty with the titles Y owned by company X. The acquisition of the Company Y is found in the consolidated balance sheet of the group X as such:

Elements	Company X	Company Y	Consolidated balance sheet after the grouping operation
Goodwill			37.750
Intangible assets	10.800	29.200	40.000
Tangible assets	20.000	7.000	27.000
Other fixed assets	100.000	3.800	18.050
Stocks	-	27.800	27.800
Claims commercial	10.000	30.000	40.000
Receivables deferred tax	-	2.800	2.800
Available	18.000	10.000	28.000
TOTAL ASSETS	158.800	110.600	221.400
Equity	80.000	64.000	80.000
Minority interests			16.000
Provisions for risks and charges	18.800	6.600	25.400
Other liabilities	60.000	40.000	100.000
TOTAL EQUITY	158.800	110.600	221.400

The success of the business combination can be analysed either by financial indicators that are found in the accounting (financial indicators, evolution of results, costs) or by the indicators used in marketing (client portfolio, sales evolution, market share, etc.) (Hramei, 2013). The advantages which have been analyzed throughout the paper, as well as strengthening the market position, achieving higher market shares or expanding on other markets, cannot be analyzed through the financial indicators from the consolidated balance sheet, but by the indicators used in marketing. The balance sheet presented is useful in the event of contracting a credit.

5. Discussions

In the current economic situation, organizations adopt different strategies in order to maximise profit, but also to strengthen the market position. Thus, one of the methods by which organisations can expand on other markets or to obtain larger quotas, is represented by the business combination by the acquisition method.

One of the benefits in the case of the business combination is obtaining higher quotas on the market. But this has certain limitations, as the Competition Council investigates any purchases that would put in danger the competitive environment and would lead to the obtaining of a monopoly within a particular market. For example, in March 2018, the Competition Council has started an analysis of the acquisition of Cemacon S.A and Cemacon Real Estate S.R.L by Dedeman S.R.L and FIP Industrial S.R.L. to determine the compatibility of the acquisition with the normal competitive environment (the Competition Council, 2018). The acquisition of an enterprise consolidates the position of the buyer on the market, by obtaining higher market shares, but also through the expansion on other markets. An example is the acquisition of the online store FashionDays by eMag in 2015. According to data from the Ministry of Finance, the turnover of eMag in 2015 was 1.7 billion lei, and in 2016 after the acquisition of FashionDays, the turnover was of 2.47 billion lei (Ministry of Public Finances, 2017).

European legislation, as well as article 101, 102 and 103 of the Treaty on the functioning of the European Union, provides strict rules on unfair competition and abusive practices regarding the competition.

In the case of a business combination, one of the disadvantages is the more difficult access to bank loans and auctions, because on the short term, there is not a cumulative turnover and a common history. However, this disadvantage can turn into long-term advantage as the turnover will increase and the history of the joint venture will generate trust. From the data presented above about the eMag, you can see the increase in the turnover of eMag, which strengthens both the market position, but also can help the company in the future in the event of contracting a credit higher than the period before the acquisition. But on the short term it is possible that the organization should not have access to larger loans due to the uncertainty in the result of the combination.

Another disadvantage, as a result of business combination carried out according to IFRS 3, is represented by the salary conditions, as the entity that buys must recognize and assess the salary benefits in accordance with IAS 19. According to IFRS 3, all assets and liabilities following an acquisition of enterprises are recognised at fair value, but one of the exceptions is the remuneration packages which can be superior to those which are already offered to employees of the buying company. For example, in China a study has been carried out in the market of acquisitions and mergers, which showed that companies in the media business consider the merger as an opportunity to enhance competitive advantage, thus taking over some assets that would help a development at the productive and technical level, through cost reduction (Deng, 2010).

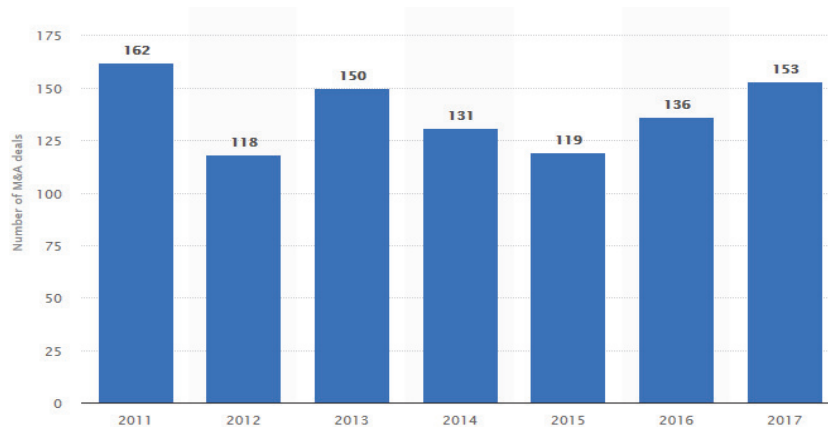


Figure 3: The number of transactions of mergers and acquisitions in Romania between 2011 and 2017 (Statista, 2018)

Analyzing the data in figure 3, it is noted that the number of transactions of merger and acquisitions has an upward trend from 2015 to 2017, which indicates that although the business combinations have certain disadvantages, they are superseded by the advantages which determine the companies to do the acquisition of other companies or of certain assets. The grouping resulting from business combinations influence the competitive environment, as it increases the market share, it is possible to decrease the cost of production and its positioning in a posture in which it can influence prices or demand and supply. The competition may respond by changing strategies, either by reducing prices, more aggressive marketing, or finding ways so that their market share is improved. A combination of enterprises is analyzed and may be prohibited by the competent authorities, such as the Competition Council, if determined the competing companies to leave the market or to put them in the obvious drawback to the new group. It can be concluded that although the groupings of businesses can influence considerably the competitive environment, European legislation analyzes, in order to prevent obtaining unfair competitive advantages, or monopolies.

At the international level, mergers and acquisitions have had an increasing global dynamic. In the year 1990, the volume of international acquisitions and mergers was \$151 billion, reaching in 2007 to a maximum of \$1.700 billion. Acquisitions and mergers at the global level have registered a decrease in 2013 as compared to 2012, from \$2.29 trillion to \$2.22 trillion. Acquisitions and mergers in the technology sector, media and telecommunications (TMT) have been on the first place in 2013, the sector encouraged significant transactions such as the Verizon/Vodafone, Liberty Global/Virgin Media and Vodafone/Kabel Germany (Hen, 2014, p.238). The total value of acquisitions and mergers in 2017, was \$4,740.97 billion, the sectors with the highest values being energy, mining and utilities. Most transactions were conducted in the US, in total value of \$1,460 billion, while in Europe, the value of acquisitions and mergers was € 93.3 million (Statista, 2017).



Figure 4: Global value of mergers and acquisitions between 2012 and 2017 (Statista, 2017)

In Romania, in terms of business combinations, according to O.M.F.P. 1802/2014, on individual and consolidated financial statements, the legislation stipulated that the acquisition process submit the final result by adding up each asset and debt account respectively. The law 571/2003 regarding the Fiscal Code with subsequent modifications and completions, stipulates that the acquisition to be highlighted by a document of

transfer which contains information on companies data, the address and the value of the acquisition, and the assets to be purchased, to be assessed individually, at fair value.

In terms of the companies that apply the O.M.F.P. 2844/2016, regarding the accounting Regulations compliant with International Financial Reporting Standards, they must have in view the recognition of deferred taxes represented by the differences which arise between the book values and tax amounts of assets and liabilities of the branch of activity, provided for by IAS 12 income Tax and accounting for positive or negative goodwill according to IFRS 3 business combinations.

In the UK, accounting for business combinations, is done according to the Standard of Financial Reporting FRS 102 (Financial Reporting Standards), as well as according to IFRS 3. Although FRS 102 is based on IFRS 3, the difference between the two consists in the fact that the deferred tax will be recognised at fair value adjustments for assets and liabilities, but the goodwill is calculated as the difference between the acquisition cost and the fair value of the assets and liabilities acquired. The CMA (Competition and Market Authority) in the UK, carries out an activity similar to that of the Competition Council, by which it investigates acquisitions or mergers which would affect competition through the possession of the monopoly.

Article 101 of the Treaty on the Functioning of the European Union, provides also exceptions on the cancellation business combinations which could affect the competitive environment, even if the group holds at least 25% of the market share, or has a turnover above 10 million euro. These exceptions apply when the grouping is aimed at the development of technologies for the benefit of consumers, however, without totally limiting the competition, when there are entry barriers on the market, or when the consumer benefits from the advantages from the result of combining (Official Journal of the European Union, 2016, p.88). For example, the grouping of the two pharmaceutical companies to get a particular medicine which would be of benefit to consumers would represent an exception even if the market share of the two would be greater than 25%.

Romania uses the continental accounting system, while the UK uses the Anglo-Saxon accounting system. The difference between them lies in the fact that in Romania the accounting system is influenced by the legal form of transactions and tax regulations, relying on the principle of 'prudence', while the Anglo-Saxon accounting system is based on the principle of 'true and fair view', drawing up transparent financial statements necessary to potential investors or other users.

6. Conclusions

According to IFRS 3, the acquisition method is the only accepted method for accounting for business combinations. This method involves the identification of the buyer, the evaluation at fair value of the assets and liabilities of the entity acquired at the time of purchase, regardless of the method of remuneration of the acquisition (shares or cash) and the legal form of combination.

The IASB approves the fact that most business combinations are represented by purchases, but do not deny the probability of the existence of “real” interest unions in which the buyer cannot be identified, although he did not have success in finding some objective criteria for defining them. The acquisition method requires identification of the buyer after evaluation of the circumstances related to the transaction, a decision which has a significant effect on the financial statements prepared after the combination.

According to IFRS 3, all intangible assets identifiable of the entity acquired are distinctly recognized and assessed at fair value. Thus, the mode of their assessment affects the size of the goodwill and of the possible expenses in the future with the amortisation or depreciation. Intangible assets with indefinite life are attractive, because they are not amortized, but are subjected to an annual test for impairment.

Through the use of the IFRS 3, it is used a international financial reporting common language which allows users to more easily understand the necessary information, so that the interpretation of the accounting to be relevant and consistent.

Taking into consideration the information presented, business combinations presents both advantages and disadvantages to the acquirer, but also has an influence on the competitive environment which must be taken into account. Although studies and statistics on this subject have not reached a final result, each organization may be influenced more or less by the business combinations depending on the number of competitors, the market in which it operates the success of the group, the type of products, as well as others. Business combinations affect in some extent the competitive environment, but not to exceed certain limits, the EU legislation prohibits and restricts any purchases which would jeopardize the competitive environment by obtaining the monopoly, or the practice of abusive strategies. Analyzing the data presented, it can be seen that the advantages obtained from business combinations far outweigh the disadvantages, this fact being supported by the increasing number of acquisitions in recent years.

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