The Road to Convergence

BUSINESS COMBINATIONS UNDER IFRS AND GAAP
As the global economy heats up, so will the need for accurate financial snapshots of new and emerging companies, many of which may become ripe for a partnership—or acquisition or merger—with a U.S.-based corporation. Management accountants, along with their teams of financial professionals, will increasingly be tasked with helping the dealmakers get a handle on not only hard assets, but intangible ones like patents and goodwill, to the benefit of upper management, investors, and others with a solid stake in the company.

To this end, International Financial Reporting Standards (IFRS) have been of keen interest to the profession for several years as more and more companies, financial professionals, and investors see the need for a common worldwide accounting language. Established by the International Accounting Standards Board (IASB), IFRS has been adopted by more than 100 countries, including Australia, most of Europe, and many countries in Asia. As increasingly more companies around the globe adopt IFRS, interest in developing a single set of high-quality standards escalates.

The United States, though, has come late to the party. In 2008, the Securities & Exchange Commission (SEC) announced a proposed roadmap for U.S. adoption of IFRS. This roadmap established seven milestones that, if fulfilled this year, would result in a required standard change by 2014. Yet despite good intentions, progress has been slow. As of December 2010, the deadline for meeting the seven milestones had been pushed out to the end of 2011, and the SEC approved a new timeline where 2015 would be the earliest year in which U.S. companies would be required to use IFRS. Whether or not this actually happens in 2015 is unknown, but many experts feel the convergence is inevitable.

The initial steps toward global standardization date back to 2002 when, as part of the movement toward IFRS, the Financial Accounting Standards Board (FASB) and the IASB issued a Memorandum of Understanding referred to as the “Norwalk Agreement.” The Norwalk Agreement outlined several critical issues for the Boards to address as part of the convergence process, one of which was the accounting for business combinations and consolidations. Since IFRS is more principles-based and U.S. GAAP (Generally Accepted Accounting Principles) is more rules-based, there were many differences in the way standards were applied. By taking up business combinations (and other topics) in a parallel fashion, the Boards could focus on the best practices of each system to develop consistent, high-quality standards. Because of this project, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 141R, “Business Combinations,” in late 2007. (From here on in this article, we’ll refer to SFAS No. 141R as “ASC 805,” which is the corresponding section in the Accounting Standards Codification™ that applies to business combinations for which the acquisition date was on or after December 15, 2008.)

In January 2008, the IASB issued a revision, IFRS 3, a collaboration that resulted in the accounting for business combinations and consolidations coming closer to convergence. In short, despite the revisions to both GAAP and IFRS, we’re not there yet. Nevertheless, to ready themselves for the coming of IFRS, management accountants who prepare financial statements—and the folks who rely on them—must understand the differences in the two accounting languages and how they affect reporting business combinations and consolidations. (For more on SFAS No. 141R/ASC 805, see “The M&A Impact of SFAS No. 141R” in the November 2008 issue of Strategic Finance.)

The Fundamental Accounting Model

Under current standards, both Boards have adopted the acquisition method for business combinations. The acquisition method is somewhat similar to the old pur-
Clear identification of the acquirer.

Recognition and measurement of the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest (NCI) in the acquiree.

Recognition and measurement of goodwill or a gain from a bargain purchase. A bargain purchase would be any in which a company pays less than the fair market value (FMV) of the company it acquires.

Where the Standards Don’t Converge

Despite the efforts to achieve convergence with the issuance of SFAS No. 141R (ASC 805) and IFRS 3, several key differences remain. The biggest issues are the definitions of what constitutes control, contingent consideration, and measuring the NCI. These issues remain a topic of concern to both the SEC and the IASB and will need to be ironed out. Let’s look at each of these in more detail.

Control. The fundamental difference between GAAP and IFRS is the definition of “control,” which affects what transactions qualify as business combinations and are thus subject to consolidation. As you might have guessed, the Boards define and apply the concept of control somewhat differently. Under GAAP, a “controlling financial interest” determines which business acquisitions would require consolidation and accounting under ASC 805. In practice, this has been interpreted to mean having an absolute majority of the voting interest of the acquired entity. Therefore, if a company following GAAP acquires more than 50% of another entity’s voting stock, it must follow ASC 805 and consolidate the entity. If it acquires less than 50% of the voting shares, it doesn’t consolidate, but it would likely apply equity accounting to the investment.

The primary focus under IFRS is on the power to control. The definition of control is the “power to govern the financial and operating policies of an entity to obtain benefits from its activities” (IAS 27, “Consolidated and Separate Financial Statements”). There’s no bright-line ownership test; instead, an acquiring company must make a judgment based on a series of indicators. Among these would be the ability to appoint management, the power to dissolve an entity, the ability to appoint members to the board of directors, voting rights, and the power to change the charter or bylaws. In practice, this may mean that a company that acquires less than 50% of an entity may fully consolidate the acquired organization in its financial statements, or it may acquire more than 50% and not be required to consolidate. Either way, consolidated financial statements under IFRS or GAAP may not be easy to compare.

Contingent Consideration. The IASB and the FASB have adopted very similar requirements for the recognition and measurement of assets and liabilities arising from contingencies. The difference lies in the criteria for initial recognition. Under IFRS, the acquirer records a liability for a contingent consideration at the acquisition date if the contingency is a present obligation arising from a past event and its fair value can be “measured reliably.” Under IFRS 3, even if the contingent obligation is probably not going to require an outflow of resources, the fact that the obligation can be measured reliably means it must be recorded.

In contrast, ASC 805 requires the acquiring company to recognize, as of the acquisition date, the assets acquired and liabilities assumed that arise from contractual contingencies, measured at their acquisition-date fair values. The acquirer must recognize noncontractual contingencies as an asset or liability as of the acquisition date if it’s more likely than not that the contingency gives rise to an asset or a liability as defined in Statement of Financial Accounting Concepts No. 6, “Elements of Financial Statements.” Noncontractual contingencies that fail the more-likely-than-not threshold as of the acquisition date are accounted for in accordance with other GAAP, including ASC 450, “Contingencies.”

If the contingency meets the threshold for recording under either IFRS 3 or ASC 805, it’s recognized at its acquisition-date fair value. These differences would suggest that the acquirer might recognize contingencies more frequently under IFRS than under GAAP. In fact, under IFRS 3 the criterion of “measured reliably” may result in more contingent liabilities being recorded during a business combination than would otherwise be recorded by companies following IAS 37, “Provisions, Contingent Liabilities and Contingent Assets.”

Whereas ASC 805 provides guidance for applying the more-likely-than-not criterion for recognizing noncontractual contingencies, IFRS 3 gives no direction in this regard.
Noncontrolling Interests. An NCI arises in business combinations when the acquiring company obtains less than 100% of the acquiree. Outside shareholders continue to hold shares of the acquired company, and their interests are recognized in the consolidated financial statements of the new organization. ASC 805 requires that the NCI be measured at fair market value. Even though the acquirer doesn’t own 100% of the acquiree, the purchaser writes the assets and liabilities of the acquiree up or down to their full FMV as if it had been fully absorbed. The acquirer recognizes the NCI in the consolidated balance sheet at FMV as a separately identified item in shareholders’ equity. Goodwill or bargain purchase gains are based on the sum of the amounts that the acquiring company records for the transaction and the amount it records for the NCI, less the FMV of the net identifiable assets. Goodwill is allocated between the acquirer and the NCI based on their relative ownership values, but all bargain purchase gains are attributed to the parent.

IFRS 3 allows the acquirer to choose between recording the NCI at fair value (as with GAAP) or its proportional share of the acquiree’s identifiable net assets (the proportional method). Under the proportional method, the purchaser bases goodwill on its share of the excess FMV over the book value only, which generally results in lower amounts of recorded goodwill. A company that engages in multiple acquisitions can make this election on a transaction-by-transaction basis, giving it the flexibility to record some at fair value and others at the proportional book value.

The option to use a different basis for the NCI will affect the amount of total assets, liabilities, or both—with fair values different from their book values—as well as the amount of goodwill recorded. Table 1 is a very simple illustration of how this might affect the recorded values.

### Is the Goodwill “Impaired”?

Any discussion about consolidation of financial statements isn’t complete without touching on goodwill. Both ASC 805 and IFRS 3 have similar criteria for the recogni-

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**Table 1: Calculating Goodwill**

On January 1, 2008, Par Company bought 80% of Sun Company in a business combination. Par paid $300,000 for 8,000 of the outstanding 10,000 shares of Sun. At the date of acquisition, the book values and fair values of Sun were:

<table>
<thead>
<tr>
<th></th>
<th>Book Value</th>
<th>Fair Value</th>
</tr>
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<tbody>
<tr>
<td>Short-term Assets</td>
<td>$30,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Equipment (5-year Remaining Life)</td>
<td>75,000</td>
<td>70,000</td>
</tr>
<tr>
<td>Land</td>
<td>225,000</td>
<td>275,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(80,000)</td>
<td>(80,000)</td>
</tr>
</tbody>
</table>

**GAAP (full FMV method):**

Assuming that shares of Sun are trading at $37.50 and that price represents the fair value, the NCI is recorded at $75,000 in the equity section of the balance sheet. Goodwill is calculated as the difference between the parent and NCI values and the FMV of Sun at the date of acquisition: ($300,000 + $75,000) – $295,000 = $80,000.

In the consolidated financial statements at the date of acquisition, Par records the equipment at $70,000 and the land at $275,000 (their FMV). All other assets and liabilities have book values equal to their fair values, so no adjustment is necessary.

**IFRS (proportionate interest method):**

Under the proportionate interest method, Par records the NCI at $50,000: 20% of the book value ($250,000). Goodwill is the difference between the acquirer’s value and 80% of the fair value: $300,000 – $236,000 = $64,000.

In the consolidated financial statements at the date of acquisition, Par records the equipment at $71,000 and the land at $265,000 (100% of book value + 80% of excess fair value over book value). All other assets and liabilities have book values equal to their fair values, so no adjustment is necessary.
tion of goodwill and bargain purchase options. At the date of acquisition, the acquiring company determines the amount of goodwill (refer to the section on NCI for the calculation of goodwill). Under ASC 805, the acquirer assigns goodwill to the various reporting units of the combined entity (a reporting unit is an operating segment or one level below an operating segment). But under IFRS 3, goodwill is assigned to the various cash-generating units (a cash-generating unit (CGU) is the smallest identifiable group of assets that generates cash inflows independently of other assets or groups of assets).

Under both GAAP and IFRS, goodwill must be tested for impairment. As we’ve already said, there may be differences in recorded goodwill if there are NCI transactions. For purposes of impairments, however, IAS 36, “Impairment of Assets,” requires a company to “gross up” the carrying amount of goodwill for impairment testing if an NCI exists. This will have the effect of using the full-goodwill method. Despite this adjustment, there are also significant differences in the impairment tests required for goodwill under either reporting system.

**GAAP.** Under ASC 350, “Intangibles—Goodwill and Other,” an organization must test goodwill at least annually for impairment. The impairment test is a two-step process.

First, the company must determine if the current fair value of the reporting unit is greater than or less than its carrying value including goodwill. If the current FMV of the reporting unit is greater than the unit’s carrying value including goodwill, then goodwill isn’t impaired. If the current FMV is less than the carrying value of the reporting unit, then the second step is necessary.

In the second step, the company must first compute the implied goodwill of the reporting unit—the difference between the current FMV assessment of the unit as a whole and the current FMV of the individually identifiable assets and liabilities. Once this calculation is made, the implied fair value of the reporting unit’s goodwill is compared to the carrying value of the goodwill. If the implied fair value of the goodwill is less than its carrying value, the difference is the amount of the impairment loss. Any loss recognized can’t exceed the carrying value of goodwill.

**IFRS.** Under IFRS, too, goodwill must be tested for impairment, but the test is a simpler one-step process, conducted at the CGU level. For goodwill, this is the lowest level at which internal management monitors goodwill.

### Table 2: Impairment Testing

Par Company is conducting an impairment review on TAP, one of its reporting units. At the time of the impairment test, Par assesses the overall current fair value for the entire TAP unit at $580,000, and the current FMV of the assets and liabilities is shown in the table below. From these amounts, the implied goodwill of $155,000 is calculated as the difference between the overall carrying value and the current FMV of the net assets ($580,000 – $425,000).

<table>
<thead>
<tr>
<th>Carrying Value</th>
<th>Current Fair Value</th>
</tr>
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<tbody>
<tr>
<td>Tangible Assets</td>
<td>300,000</td>
</tr>
<tr>
<td>Patents</td>
<td>190,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>150,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(30,000)</td>
</tr>
</tbody>
</table>

**GAAP:**
Step 1 compares the current fair value of $580,000 to the carrying value of $610,000. Since the fair value is less than the carrying value, step 2 is required. For step 2, since the implied fair value of goodwill ($155,000) is more than the carrying value ($150,000), no impairment loss is recorded.

**IFRS:**
To keep this relatively simple, assume the current fair value of $580,000 meets the definition of recoverable amount value under IFRS. An impairment loss would be recorded since the carrying value of $610,000 exceeds the recoverable amount by $30,000. In this case, the impairment loss would reduce the carrying value of goodwill from $150,000 to $120,000.
and it can’t be larger than any operating segment. An entity will allocate goodwill to CGUs or groups of CGUs that will benefit (or are expected to benefit) from the synergies of the business combination from which the goodwill arose. If the cash-generating unit’s carrying amount, including goodwill, exceeds its recoverable amount, the difference is first allocated to reduce goodwill to zero, and then the carrying amount of other assets in the CGU is reduced proportionately based on the carrying amount of each asset.

There are two scenarios where differences would arise. The first would be a situation in which the unit’s current FMV (or recoverable value under IFRS) is below its carrying value but the implied fair value of the goodwill is greater than its carrying value. Under GAAP, no impairment loss is recognized; under IFRS, however, the entity recognizes an impairment loss for the difference between the unit’s recoverable value and its carrying value.

A second scenario would be when the unit’s current FMV is below the carrying value and the implied goodwill is zero. Under GAAP, goodwill is impaired and written down to zero. If the current recoverable amount under IFRS is below the carrying value and the difference exceeds the amount recorded as goodwill, the impairment loss would zero out goodwill and reduce the carrying value of other net assets. Table 2 spells things out in more detail.

Other Issues Related to Consolidated Financial Statements

In addition to the preceding issues, other differences will surely crop up in interpreting consolidated financial statements under IFRS and GAAP. Some areas where differences still exist include the accounting for employee benefit plans, inventory, impairment of long-lived assets, and reversal of impairment losses. For example, both ASC 805 and IFRS 3 require that the assets and liabilities related to the acquired entities’ employee benefit plans be recognized and recorded using the respective U.S. and international standards. This means, of course, that there won’t be any consistency in the consolidated presentation.

In another wrinkle, IAS 2, “Inventories,” doesn’t allow use of the last-in, first-out (LIFO) method of inventory valuation that entities using GAAP widely apply. Like GAAP, IAS 2 allows an entity to write down inventories, but, unlike GAAP, under IFRS a unit may recognize a recovery when the circumstances that previously caused the write-down no longer exist.

Moreover, differences in the testing for the potential impairment of long-lived assets may lead to earlier impairment recognition under IAS 36 than under ASC 360-10-35, “Property, Plant, and Equipment—Overall—Subsequent Measurement.” ASC 360 requires a review for impairment whenever events or circumstances change, indicating that the carrying amount of an asset may not be recoverable. IAS 36, on the other hand, demands a review for impairment indicators at each reporting date. IFRS requires the use of entity-specific discounted future cash flows or a fair value measure in tests for an asset’s recoverability. By comparison, GAAP uses a two-step approach that starts with undiscounted future cash flows. This basic variation in the impairment models can make a difference between an asset being impaired or not.

In general, IFRS allows impairment losses on assets (other than goodwill) to be reversed. On the other hand, while GAAP recognizes impairment losses in most cases, it doesn’t allow reversals.

Looking Ahead

Whether your organization perceives the coming of IFRS as a threat or an opportunity may depend on where you work, as well as how much you and your accounting team know about the international standards and how they compare to GAAP. For some multinational firms whose subsidiaries report under IFRS, the movement toward IFRS in the United States may actually streamline accounting operations and save them the considerable costs of maintaining, then reconciling, two accounting systems. For other companies that lack a staff fluent in IFRS, the process of getting up to speed may seem daunting and costly. Nevertheless, the process of convergence is likely to make the transition easier over time as standards under the two systems become similar. But as we’ve seen, even convergence projects that have been deemed successful still leave substantial gaps between what we’re accustomed to under GAAP and what IFRS will eventually demand from us.

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