# ACCOUNTING FOR BUSINESS COMBINATIONS AND THE CONVERGENCE OF INTERNATIONAL FINANCIAL REPORTING STANDARDS WITH U.S. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES: A CASE STUDY

**Marianne L. James, California State University, Los Angeles**

## CASE DESCRIPTION

*The primary subject matter of this case concerns changes in accounting for business combinations and the convergence of International Financial Reporting Standards (IFRS) with U.S. Generally Accepted Accounting Principles (GAAP). The case focuses on the effect of the changes on financial statements of global entities, as well as strategic decisions made by company executives.*

*Secondary, continuing significant differences between U.S. GAAP and IFRS and future potential developments in accounting for consolidated multinational entities are explored. This case has a difficulty level of three to four and can be taught in about 50 minutes. Approximately three hours of outside preparation is necessary to fully address the issues and concepts. This case can be utilized in an Advanced Accounting course, either on the graduate or undergraduate level to help students understand changes in and differences between U.S. GAAP and IFRS. Two sets of questions address U.S. GAAP and IFRS and include researchable questions that are especially useful for a graduate level course. The case has analytical, critical thinking, conceptual, and research components. Utilizing this case can enhance students' oral and written communication skills.*

## CASE SYNOPSIS

*Financial reporting in the U.S. is changing dramatically. Consistent with the Securities and Exchange Commission's proposed "Roadmap" (SEC, 2008), the U.S. likely will join the more than 100 nations worldwide that currently utilize International Financial Reporting Standards (IFRS), and require the use of IFRS in the U.S.*

*Because of the globally widespread use of IFRS, multinational entities with subsidiaries that prepare IFRS-based financial statements already have to be knowledgeable about IFRS as well as the current differences between U.S. GAAP and IFRS. Fortunately, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are working*

*together to bring about convergence between the two sets of accounting standards.*

*Recently, FASB and the IASB issued new and revised several existing standards that eliminate many differences between U.S. GAAP and IFRS with respect to business combinations and consolidated financial statements. However, some significant differences persist. Until the SEC makes a final decision regarding the mandatory use of IFRS, and during the proposed multi-year transition period, current and future accounting professionals must continue to keep abreast of changes in U.S. GAAP, be knowledgeable about differences between U.S. GAAP and IFRS, and, at the same time, prepare for the likely transition to IFRS. In addition, company executives should be cognizant of developments that may affect their strategic decisions as the U.S. moves toward a likely adoption of IFRS during the next five years.*

*This case focuses on the effect of changes in financial reporting for business combinations. Changes as well as continuing differences between U.S. GAAP and IFRS are explored. Secondarily, strategic decisions arising from the changes and the likely future adoption of IFRS are addressed. This case, which can be utilized in Advanced Accounting on either the graduate or undergraduate level can enhance students' analytical, technical, critical thinking, research, and communication skills.*

## INTRODUCTION

Financial accounting and reporting in the U.S. is changing rapidly. During the past six months, the Financial Accounting Standards Board, the primary accounting standard setter in the U.S., issued twelve (12) new standards and launched its on-line "Accounting Standards Codification," which organizes existing GAAP into 90 topics (FASB, 2009). At the same time, a significantly more dramatic change is on the horizon for accounting professionals, company executives, and financial statement users.

Consistent with the SEC's 2008 proposal entitled, "Roadmap for the Potential Use of Financial Statements Prepared in Accordance With International Financial Reporting Standards by U.S. Issuers," (Roadmap) in approximately five years, public companies likely will have to utilize IFRS, instead of U.S. GAAP (SEC, 2008). In fact, some large global U.S.-based entities are permitted to early-adopt IFRS starting in 2009. The SEC expects to reach a final decision regarding the mandatory adoption of IFRS in 2011 (SEC, 2008).

If the U.S. indeed adopts IFRS as the required standard for financial accounting and reporting, the U.S. will join the more than 100 nations worldwide that currently permit or mandate the use of IFRS. For example, starting with the 2005 reporting period, all European public companies listed on any European stock exchange must prepare IFRS-based financial statements. Other nations, such as Canada, are planning to adopt IFRS in the near future.

Currently, U.S. GAAP and IFRS are not identical. However, since signing their Memorandum of Understanding, commonly referred to as the "Norwalk Agreement," in 2002, FASB and the IASB have been working together to develop a set of high-quality globally acceptable

financial accounting standards and to bring about convergence of U.S. GAAP and IFRS. Since the Norwalk Agreement was signed, many new and revised standards issued by FASB and the IASB have served the purpose of eliminating existing differences. However, while many differences have been eliminated, others persist.

Accounting for and reporting by global entities is quite complex. U.S., as well as international accounting rules require that a parent company consolidates its subsidiaries' financial statements with the parent company's financial statements. Recent standards issued by the IASB and FASB have eliminated many differences between U.S. GAAP and IFRS in accounting for business combinations and financial reporting for consolidated entities. However, some significant differences continue to exist.

## KLUGEN CORPORATION

Irma Kuhn, CPA, CMA holds the position of Chief Financial Officer (CFO) of Klugen Corporation, a global telecommunications company. Klugen is a consolidated entity headquartered in the U.S. with four majority-owned European subsidiaries. The company has expanded primarily by acquiring majority interest in European companies and holds between 51% and 70% of the outstanding voting stock of its subsidiaries. Three of these subsidiaries were acquired in stages and consolidated once the company achieved majority ownership.

Consistent with current accounting rules, Klugen consolidates all four of its subsidiaries. In addition, Klugen also holds financial interests in several unconsolidated entities and accounts for those as investments.

Klugen's European subsidiaries currently prepare their financial statements consistent with International Financial Reporting Standards (IFRS), which are promulgated by the International Accounting Standards Board (IASB). Klugen, the parent company, issues consolidated financial statements, which include the results of its majority-owned subsidiaries in conformity with U.S. GAAP. Preparation of Klugen's consolidated financial statements requires that Irma and her staff convert the subsidiaries' IFRS-based financial statements into U.S. GAAP prior to consolidating the numbers. This process is quite complex and requires many of the accounting departments' resources.

Irma is well aware of efforts between the FASB and the IASB to bring about convergence between U.S. GAAP and IFRS. She expects that consistent with the SEC's "Roadmap," (SEC, 2008) within the next five years, U.S. public companies likely will have to apply IFRS, rather than U.S. GAAP. Irma welcomes this development and believes that in the long-run, use of IFRS by the parent company as well as its subsidiaries will preserve and strengthen the company's global financial competitiveness. In addition, she believes that it will simplify the accounting and consolidation process significantly and, in the long-run, reduce financial reporting costs. She is aware, however, that in the short-run many challenges, such as conversion of the accounting and IT systems and extensive staff training will increase costs. Knowing that the SEC's Roadmap proposes a phased-in

adoption by public companies between 2014 and 2016, Irma plans to recommend adoption of IFRS at the earliest permitted time.

As the person who ultimately is responsible for financial reporting, Irma is very knowledgeable about current and proposed changes in U.S. GAAP as well as IFRS. She knows that the IASB and FASB have issued new and revised standards applicable to business combinations that affect the company's consolidated financial statements. After in depths analysis of the new and revised standards, she determined that many of the past differences between U.S. GAAP and IFRS where eliminated when the FASB issues FAS 141 R "Business Combinations" and FAS 160 "Non-controlling interest in consolidated financial statements" (FASB, 2007) and the IASB revised IFRS 3 "Business Combinations" and IAS 27 "Consolidated and Separate Financial Statements" (IASB, 2008). She also realizes that some significant differences still persist. Klugen Corporation has properly adopted FAS 141R and FAS 160 (now codified in sections 805 and 810 of FASB's 2009 Standards Codification) for the 2009 fiscal period and its forthcoming annual report will reflect those changes.

Irma regularly conducts in-house seminars to instruct her accounting staff regarding new developments in financial reporting. In fact, her seminars meet the Continuing Professional Education (CPE) sponsor requirements set forth by the National Association of State Boards of Accountancy (NASBA) and the Quality Assurance Service (QAS), which is required by State Boards of Accountancy and other licencing organizations for the renewal of CPA, CMA and other professional certifications.

Irma's CPE seminars entitled "Financial Reporting Updates" are always well received by her staff. During the past six months, Irma already has held several seminars to inform her staff regarding IFRS. Those who attended all her seminars are already familiar with the SEC's Roadmap that proposes adoption of IFRS starting in 2014, and also know about some of the most significant differences between U.S. GAAP and IFRS.

Since in about five (5) months, Klugen Corporation will issue its consolidated financial statements, which will, for the first time, incorporate FAS 160 and FAS 141R, Irma decides to schedule a seminar on "Business Combinations - Consolidated Financial Statements" for October 15, 2009. The following is a brief agenda for Irma's Seminar:

**Business Combinations - Consolidated Financial Statements - Financial Reporting Update**
October 15, 2009 - Agenda

1. Review of fundamental concepts of business combinations and consolidated financial statements
2. Changes to U.S. GAAP (FAS 141R and FAS 160)
3. Significant continuing differences between U.S. GAAP and IFRS
4. Developments with potential impact on future fiscal periods

5. Questions

The seminar will be highly beneficial for staff members who are currently involved or planning to become involved in critical aspects of financial reporting and also for those who want to develop their knowledge of IFRS. During the seminar, Irma distributes several handouts, including the company's prior year income statement and balance sheet for reference.

**Table 1**
Klugen Corporation
Consolidated Statement of Income
for the year ended December 31, 2008
Numbers are in million (except share amounts)

| | | |
|---|---|---|
| **Operating Revenues** | | |
| Business service | $15,500 | |
| Residential service | 10,200 | |
| Wireless service | 18,000 | $ 43,700 |
| **Operating Expenses** | | |
| Cost of services (excludes depreciation & amortization) | $ 15,200 | |
| Selling, general, administrative expenses | 11,100 | |
| Depreciation and amortization | 7,150 | $ 33,450 |
| **Operating Income** | | $ 10,250 |
| Other Income (Expense) | | |
| Interest expense | (820) | |
| Minority interest | (1,010) | |
| Investment income | 405 | (1,425) |
| **Income Before Income Taxes** | | $ 8,825 |
| Income Tax | | 3,250 |
| **Net Income** | | **5,575** |
| **Basic Earnings Per Share** | | $2.08 |
| **Diluted Earnings Per Share** | | $1.92 |
| The accompanying notes are an integral part of the consolidated financial statements | | |

| Table 2<br>Klugen Corporation<br>Consolidated Balance Sheet<br>December 31, 2008<br>(Numbers are in millions) | | |
|---|---|---|
| **Assets** | | |
| **Current Assets** | | |
| Cash and cash equivalents | $ 519 | |
| Accounts receivables (net of allowances of $310) | 4,200 | |
| Prepaid expenses | 400 | |
| Other current assets | 520 | |
| Total Current Assets | | $ 5,639 |
| **Non-Current Assets** | | |
| Property, plant & equipment (net) | 25,600 | |
| Goodwill | 18,500 | |
| Licenses | 12,900 | |
| Customer relationships (net) | 3,100 | |
| Investments in non-consolidated entities | 1,000 | |
| Dividends receivables | 300 | |
| Other assets | 1,200 | |
| Total Non-Current Assets | | $62,600 |
| **Total Assets** | | **$68,239** |
| **Liabilities and Stockholders' Equity** | | |
| **Current Liabilities** | | |
| Accounts payable and accrued liabilities | 5,200 | |
| Advanced billings and deposits | 920 | |
| Accrued taxes | 420 | |
| Total Current Liabilities | | $ 6,540 |
| **Non-Current Liabilities** | | |
| Long-term debt | 25,500 | |
| Post-retirement benefits | 2,300 | |
| Deferred taxes | 3,200 | |
| Total Non-Current Liabilities | | $31,000 |
| **Total Liabilities** | | **$37,540** |
| Minority Interest | | **5,000** |

| Table 2<br>Klugen Corporation<br>Consolidated Balance Sheet<br>December 31, 2008<br>(Numbers are in millions) | | |
|---|---|---|
| **Stockholders' Equity** | | |
| Common stock ($1 par, 100,000,000 authorized, 60,000,000 issued) | 60 | |
| Additional paid in capital | 13,095 | |
| Retained earnings | 14,588 | |
| Accumulated other comprehensive income | (2,044) | |
| **Total Stockholders' Equity** | | **25,699** |
| **Total Liabilities and Stockholders' Equity** | | **$68,239** |
| The accompanying notes are an integral part of the consolidated financial statements. | | |

## The Seminar

Agenda Item 1 Fundamental Concepts of Business Combinations - Consolidated Financial Statements

During the first part of the seminar, Irma reviews several fundamental concepts relating to accounting for business combinations. She emphasizes that these concepts are common to both U.S. GAAP and IFRS.

**Fundamental Concepts common to both U.S. GAAP and IFRS**

- ♦ The parent company issues consolidated financial statements that include the results for all subsidiaries that the company controls.
- ♦ Control is usually assumed when the parent holds a controlling financial interest (generally, more than 50% ownership of the outstanding voting common stock.
- ♦ Consolidated financial statements include 100% of the subsidiaries' assets, liabilities, revenue, expense, gains, and losses, even if the subsidiary is only partially owned.
- ♦ Subsidiaries' previously unrecognized assets are identified at time of business combination and are recognized in the consolidated financial statements.
- ♦ Goodwill is recognized on the consolidated balance sheet if the acquisition cost exceeds the fair value of the subsidiaries' identifiable net assets.
- ♦ Goodwill is not amortized, but periodically tested for impairment.
- ♦ Non-controlling interest (formerly called minority interest) is recognized on the consolidated balance sheet.

Agenda Item 2 Changes in U.S. GAAP

Irma discusses the most important changes in accounting and financial reporting for consolidated entities consistent with FAS 141R and FAS 160. She prepares a handout for the seminar participants, consisting of a comparative table that contrast the new rules (effective for the 2009 financial statements) with the prior rules.

**Table 3**
Recent Changes to U.S. GAAP - effective 2009 - FAS 141R and FAS 160

| Issue | Effective 2009 Financial Statements | Pre-2009 Financial Statements |
|---|---|---|
| Subsidiaries' assets and liabilities | All assets and liabilities are revalued to fair market value at acquisition date (100% revaluation). | Assets and liabilities were revalued based on the parent's ownership percentage |
| Negative goodwill | Recognized as gain for year of acquisition. | Recognized as a proportionate reduction of long-term assets. |
| Balance sheet classification of non-controlling interest (NCI) | NCI is classified as equity. | NCI is recognized as liability, equity, or between liabilities and equity. |
| Income statement presentation of NCI's share of income | Presented as a separate deduction from consolidated income to derive income to controlling stockholders. | NCI was presented as part of "Other income, expenses, gains, and losses." |
| NCI valuation | Is carried at fair market value of subsidiaries' net assets, multiplied by NCI percentage. | Carried at book value of subsidiaries' net assets, multiplied by NCI percentage. |
| Cost of business combinations | Direct costs are expensed during year of acquisition | Direct costs were capitalized as part of acquisition cost. |
| In process research and development (R&D) | Are capitalized at time of acquisition. | Could be expensed at time of acquisition. |
| Acquisition in stages | Previously acquired equity interest is remeasured when acquiring company achieves control; gain or loss is recognized in the income statement. | Measurement was based on values at time of individual equity acquisition |
| Terminology | Minority interest is now referred to as "non-controlling interest." | The commonly used term was "minority interest." |

Agenda Item 3 Significant Continuing Differences Between U.S. GAAP and IFRS

Irma highlights continuing significant differences between U.S. GAAP and IFRS. This information is particularly important for those staff members who are involved in the consolidation process and those who wish to prepare for the future adoption of IFRS. The following table represents a handout based on Irma's PowerPoint presentation:

**Table 4**
Summary of Current Differences Between U.S. GAAP and IFRS

| Issue | U.S. GAAP | IFRS |
|---|---|---|
| Definition of control | Defined as "controlling financial interest" (ARB 51).<br>Usually interpreted as majority voting interest. | Focuses on "power to govern financial and operating policies" (IFRS 3, par. 19); The goal is that activities generate "benefits" for controlling entity. |
| Shares considered for determining control | Only existing voting rights are considered. | May include exercisable shares. |
| Calculation of non-controlling interest (NCI) | NCI interest is measured at fair value of total net assets and includes share of goodwill. | Choice between (1) fair value and (2) proportionate share of fair value of identifiable net assets. |
| Calculation of goodwill at time of acquisition | Goodwill (if it exists) also includes share attributed to NCI. | If second option is chosen, goodwill is only attributed to controlling interest (parent). |
| Contingencies - initial measurement | Contractual contingent assets or liabilities are valued at fair market value. Non-contractual contingent assets and liabilities that meet the 'more likely than not' test are accounted for consistent with SFAC 6.<br>Non-contractual assets and liabilities: If they do not meet 'more likely than not test' are accounted for consistent with FAS 5. | Recognition of contingent liability: Contingent liability is recognized even if it is does not meet the 'probable' test if the present obligation<br>arises from a past event and is reliably measured. |

**Table 4**
Summary of Current Differences Between U.S. GAAP and IFRS

| Issue | U.S. GAAP | IFRS |
|---|---|---|
| Goodwill impairment test | Two-step approach: (1) compare book value of reporting unit to fair market value of reporting unit; (2) if book value is larger, impairment is equal to book value less implied fair value of goodwill. | One-step approach<br>Compare book value to larger of cash generating unit's (a) fair value less selling cost and (b) value in use [value in use = PV of expected future cash flows]. |

Agenda Item 4 Developments with Potential Impact on Future Fiscal Periods

Irma briefly mentions other developments in the consolidation area. She mentions that in June 2009, FASB issued FAS 166, "Accounting for Transfers of Financial Assets," and FAS 167, "Amendments to FASB Interpretation No. 46R" (FASB, 2009). FAS 166 eliminates the concept of qualifying special purpose entities (SPE); FAS 167 deals with the consolidation aspects of this elimination. Specifically, companies with formerly classified qualifying SPEs must now assess these entities for possible consolidation.

FAS 167 focuses on control and the primary beneficiary of the SPE in determining whether a company, such as Klugen Corp., must consolidate its SPE. A primary beneficiary is (1) able to direct activities of the SPE and is required to absorb significant gains and losses. A company is assumed to have control if (1) it has the power to direct activities, (2) has the most significant impact on the entity's performance, and (3) is required to absorb losses, and benefit from gains (FAS 167, par. 14A-G). Irma reminds her staff that currently Klugen Corporation does not have investments in qualifying SPE's; thus, the new standards will not affect the company.

Irma also mentions that in December 2008, the IASB issued Exposure Draft 10 (ED 10) "Consolidated Financial Statements," (IASB, 2008), which proposes a single definition of control that is very similar to the FAS 167 definition. Once this exposure draft is finalized, convergence between U.S. GAAP and IFRS likely will be further enhanced. Irma promises to keep her staff informed about developments in that area.

Agenda Item 5 Questions

At the end of the seminar, many questions arise from the staff and some from the CEO, who attended the second half of the seminar. Irma answers as many questions as possible and promises to prepare a short question/answer briefing sheet for all those who

were present at the seminar. During the seminar she summarizes the following questions as shown in the Assignments section.

## ASSIGNMENTS

Answer the questions specifically assigned by your instructor.

**U.S. GAAP Questions**

1. How will adoption of the new accounting standards (FAS 141R and FAS 160) affect Klugen Corporation's financial statements in the forthcoming reporting period?

2. Utilizing the 2008 numbers, prepare (1) a partial income statement starting at income from operations and (2) the equity section of the balance sheet consistent with the requirements of FAS 141R and FAS 160 (FASB Accounting Standards Codification sections 805 and 810).

3. How will adoption of FAS 141R and FAS 160 affect Klugen Corporation's financial statements in the long-run?

4. What key financial ratios will be affected by the adoption of FAS 141R and FAS 160? What will be the likely effect?

5. What additional estimates have to be made consistent with the new accounting standards?

6. Could any of the recent and forthcoming changes affect the company's acquisition strategies and potentially its growth?

7. What were FASB's primary reasons for issuing FAS 141R and FAS 160? (Research question)

8. What are qualifying SPEs? Do they exist under IFRS? What is the effect of FAS 166 eliminating the concept of qualifying SPEs on the convergence of accounting standards?

9. FASB and IASB recently issued an updated Memorandum of Understanding. Retrieve the updated memorandum and identify several issues that the two standard setting boards are jointly focusing on to facilitate convergence. (Research Question)

**IFRS Questions**

1. From the consolidation perspective, what would be the likely overall effect of adopting IFRS on the company's financial statements?

2. What potential effect would arise if Klugen were to select the option under IFRS 3 to value non-controlling interest at the proportionate share of its subsidiaries' net identifiable assets?

3. Do you believe that an impairment of goodwill would be more likely under IFRS or under U.S. GAAP? Why, or why not?

4. What challenges would arise for the accounting staff if the company adopts IFRS? Do you believe that he company is making progress toward meeting some of these challenges?

5. What opportunities would arise for the accounting staff if the company adopts IFRS?

6. What other (non-staff related) factors should Klugen Corporation consider prior to adopting IFRS? Differentiate between advantages and disadvantages.

7. Two of Klugen's non-consolidated entities regularly grant stock options to its employees. How could this affect Klugen's accounting for these entities under IFRS?

8. As indicated in the case, Irma previously highlighted some other significant differences between IFRS and U.S. GAAP. Research the issue and find three (3) differences other than those related to business combinations. You may want to consider accounting for inventory, extraordinary items, property, plant and equipment, and research and development.

9. Assume that the SEC provides a choice in the timing of the adoption of IFRS. What ethical issues could arise for the CFO in deciding whether to adopt IFRS at the earliest possible, or at a later required date? (Research question)

10. Review comment letters received by the SEC regarding its Roadmap. List two concerns mentioned by those offering comments. (Research question)

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## AUTHOR'S NOTE

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