EFRAG
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18 December 2014

Dear Sirs

Short Discussion Series:
Presentation of the Reversal of Acquisition 'Step-Ups'

1. I am writing in response to the above paper. This letter has not been discussed by the FRC or its Accounting Council: the views expressed in this letter are staff views only.

2. I agree that following an acquisition cost of sales is inappropriately increased by the step up to fair value of inventory, and that this fails to provide a fair reflection of the results of the period or a meaningful basis for the assessment of future results. In my view, this arises because 'fair value', which is defined as an exit value, is not a relevant measurement basis. As inventory is an input to the entity's business model, replacement cost, which is an entry value, would be relevant (although naturally net realisable value would be appropriate if lower than replacement cost). This would be consistent with the UK standard, FRS 7 *Fair values in acquisition accounting*[1].

3. A business combination would not usually be expected to change the replacement cost of inventory, so in most cases it would be expected that the value ascribed to inventory would be the same as cost in the books of the acquired entity. A difference would, however, arise where there are significant changes in prices in the period from the acquisition of the inventory to the date of the acquisition. In such a case, it is appropriate for the inventory to be stated at values that reflect the economic circumstances prevailing at the date of the acquisition. But there would be no adjustment to reflect the profit margin considered to be attributable to activities performed by the acquiree prior to the date of acquisition. The reported margin for the period after the acquisition would be the difference between the price obtained on sale and the deemed cost of the inventory on acquisition, which, as stated above, would usually be the same as cost to the acquired entity.

4. Replacement cost is also appropriate for assets such as property, plant and equipment, although it will often be the same as fair value as required by IFRS 3. As such assets are held for the longer periods, the effect of price changes will more often be significant. However, as the paper observes (at paragraph 21), this is likely to be more predictive than information that reflects the historical cost to the acquired entity.

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[1] For accounting periods beginning on or after 1 January 2015 FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* will be effective and FRS 7 will be withdrawn.

5. As the paper notes, application of IFRS 3 may also result in the recognition of intangible assets that were not previously recognised by the acquiree, as they were internally generated and did not meet the recognition criteria of IAS 38 *Intangible Assets*, paragraph 21. These criteria are disapplied (by paragraphs 33 and 34 of IAS 38) in the case of intangibles resulting from a business combination. As was reported at the September meeting of the IASB's Accounting Standards Advisory Forum, the FRC has urged, based on its research with investors, that this should be reconsidered, perhaps by requiring only 'wasting' intangible assets to be recognised and not those that are organically replaced. Such an approach would clearly reduce the amount of 'step ups'.

6. The paper suggests (in paragraph 6) that valuation of acquired assets at fair value is justified because:

> The management of the acquirer should be assessed on the results obtained from the moment they have taken control of the business acquired. Allowing for the contrary would distort economic reality and create an accounting incentive to use acquisitions in order to show profit in the Group accounts as if it had been created by the reporting entity and not purchased from others.

7. This observation is based on the view that profit is the result of the totality of an entity's activities, and should be apportioned between them. For example, for an entity engaged in manufacture, some profit relates to each of: purchasing supplies; manufacturing goods; and delivering them to customers. This implies that the value of the acquired inventory of finished goods should include the profit that relates to activities such as purchasing and manufacturing.

8. This is not the view that is adopted in accounting, where profit is taken when control of the goods is passed to the customer, and inventory is stated at cost without any addition for profit. One reason for this is that the allocation of profit to distinct parts of the business process is inherently arbitrary as there is usually no market available that can demonstrate the value created by each part. Another is that it provides information on the performance of the whole of the entity's business model in the same period, without arbitrary divisions between periods. I would also suggest that recording inventory at an amount greater than replacement cost overstates the value of the inventory to the entity, because, by definition, the entity is able to replace its inventory at replacement cost.

9. I understand the view that the recognition of assets at less than fair value results in 'purchased profits' being reported in the post-acquisition period. However, the acquirer accounts for what it has purchased by recording goodwill, which some rationalise as representing the above-normal profits expected from an acquisition.

10. In my view, therefore, the requirements of IFRS 3 for the measurement and recognition of assets and liabilities should be reconsidered. However, as it is unlikely that the IASB will wish to do so, it is relevant to consider the alternative solutions set out in the paper. My comments on these follow.

(a) *Disaggregating the cost of goods sold and presenting the impact of the step-ups in a separate line item of the statement of comprehensive income*

I agree with the view of the European enforcer discussed in paragraphs 32-34 that cost of sales includes the amounts previously attributed to inventory, so that it would be inappropriate to present the reversal of the step-up to inventory separately from cost of sales (as illustrated in paragraph 35). I also agree with the enforcer's view that it would be adequate to highlight the effect of the reversal of a step-up of inventory by additional disclosure: this would often be best made in the notes to the financial statements, which would avoid cluttering the income statement.

(b) *Offsetting the revenue and cost of goods sold for the performance completed by the acquiree before the acquisition date*

I do not agree that revenue should exclude an amount attributable to activities performed before the business combination. This would be contrary to the principle set out in paragraph 31 of IFRS 15, which requires that revenue is recognised when a performance obligation is satisfied by transferring a promised good or service to a customer. It follows that no performance is completed by the acquiree before the acquisition date, and that all the revenue relates to the post-acquisition period.

(c) *Presenting cost of goods sold based on the acquiree's carrying amounts in profit or loss and the reversal of the step-ups in other comprehensive income*

This approach seems consistent with some elements of the IASB's recent thinking that, where one measurement attribute is considered most relevant for the statement of financial position and another for the statement of profit or loss, the difference should be reported in other comprehensive income ('OCI'). The objections given in the paper (at paragraphs 44-45) are unconvincing. There is no clear basis for concluding that excluding the reversal of the step-up from the statement of profit or loss would overstate earnings: obviously earnings would be greater but the proposition that they would be overstated requires a precise concept of 'earnings' which is not stated. The absence of a basis to recycle the amount reported in OCI is only a disadvantage for those who consider (and I do not) that all items reported in OCI should be recycled.

Nonetheless, I would not support this approach, as, in my view, the number of items reported in OCI should not be increased. Clearly, this approach cannot be implemented unless accounting standards are amended, as IAS 1, paragraph 88 requires all income and expenses to be recognised in profit or loss, unless an IFRS permits or otherwise requires. Also, the objection noted to approach (a)—that cost of sales is defined in IAS 2—would also apply to this approach.

(d) *Disclosing the information necessary to users interested to make the adjustment*

As noted in paragraph 54 of the paper, it is possible for any entity to provide information, including the effect of the reversal of step-ups where it believes such information is relevant and material. It is not clear that the issue is sufficiently widespread to require a specific disclosure requirement. A

voluntary approach to disclosure would enable entities to judge what disclosure is appropriate to their circumstances, which may vary widely. Reversals of step-ups to inventory will often all be recognised by the end of the accounting period following the acquisition, but step-ups to property plant and equipment may reverse over many years, although it would probably be excessive to require disclosure for all the accounting periods of a property's remaining useful life.

11. In summary:

- The problems addressed in the paper are mostly due to the use of an incorrect measurement attribute. They would not arise if replacement cost (or net realisable value, if lower) were used rather than fair value.

- I am not convinced that the IASB should introduce new requirements to improve the information on the reversal of acquisition step-ups. It seems adequate for the entity to decide what information is relevant and material and needs to be provided.

Yours faithfully

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