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European Financial Reporting Advisory Group
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By email to commentletters@efrag.org

Dear Sirs,

Response to EFRAG Short Discussion Series – Presentation of Reversals of Acquisition "Step-Ups"

I am writing to respond, in my personal capacity, with comments on the above discussion paper (DP) issued by the European Financial Reporting Advisory Group (EFRAG) in September 2014. The views set out in this letter are mine and they do not necessarily reflect those held by the firm in which I am a partner, the national accounting standards setting body of which I am a council member or the professional bodies of which I am a member.

I would like to commend EFRAG for identifying a classic accounting issue encountered by the acquirer in a business combination and for providing a rigorous and comprehensive analysis that serves as a basis for further discussion and debate.

Before answering the two specific questions in the DP, I would like to make some general observations.

Reversal of acquisition step-up is merely an accounting mechanics

As explained in the DP, the profit margin of the acquirer of a business in the post-acquisition years may be lower than "normal" for a number of reasons. I would like to list the following as the *business* reasons (not exhaustive) that cause the acquirer to have a lower (or higher) profit margin:

(a) The acquirer of the business will have to effectively pay the full cost plus a profit margin attributable to the seller for transferring the raw materials, semi-finished products and finished products (for property developers, these include land, property under development and completed property) at fair value;

(b) The acquirer of the business will have to bear amortisation expense on any intangible assets developed by the seller now transferred to the acquirer at fair value;

(c) The acquirer of the business will have higher/lower depreciation/rental expense on property, plant and equipment or rental agreements transferred by the seller at fair value;

(d) The acquirer of the business will have to bear interest expense at a new effective interest rate on borrowings transferred by the seller at fair value.

It is important to note that from a business perspective, (a) and (b) above will cause the acquirer to have a lower post-acquisition profit margin than the pre-acquisition profit margin achieved by the acquiree while (c) and (d) will cause the post-acquisition profit margin to be lower or higher depending on the circumstances.

In fact, if the acquirer had not acquired the entire business but had only acquired any of the assets or assumed any of the liabilities at fair value, it would have faced a similar issue for its profit margin.

The purchase price allocation process is to establish the new cost to the acquirer of the business, instead of the old cost to the seller of the business, as if the acquirer had purchased each of the assets and assumed each of the liabilities at fair value at the date of acquisition.

Clearly, the subsequent reversal of acquisition step-up is merely an accounting mechanics of applying fair value accounting so as to enable the acquirer to reflect a higher or lower cost in its consolidated income statement. For this reason, I am of the view that stating our current issue as one about the "presentation of reversals of acquisition step-ups" may not be as enlightening as one that focuses on how the acquirer should present the effects from (a) to (d) above in its consolidated income statement.

The DP suggests that the effects of (b) to (c) do not pose a major presentation issue as the information presented is predictive of future performance. On the other hand, the DP highlights some preparers' concerns that the effect of (a) could lead to a distorted profit margin that is not predictive of future performance. It then explores a number of options for the acquirer to isolate the effect of the "reversal of acquisition step-up" in its consolidated income statement.

I now turn to the two specific questions in the DP.

Q1 Do you believe that the IASB should introduce new requirements to improve the information on the reversal of acquisition step-ups? If not, why not?

In my view, the reversal of acquisition step-up is merely an accounting mechanics for the acquirer to charge an incremental cost in its consolidated income statement, over and above the acquiree's old cost base, such that the acquirer will present fairly its actual cost or expense in its consolidated income statement. If the acquirer's profit margin in the first year of acquisition (or the second year if the acquisition occurs towards the end of the first year) is depressed by the effect of higher inventory cost as the raw materials, semi-finished products and finished products brought into the group are sold within a few months from the date of acquisition, this is a faithful representation of the acquirer's business performance during the transitional period. The accounting mechanics should not be blamed for depressing the actual profit margin or for producing information that is not predictive of future performance.

There is no conceptual merit in suggesting that the acquirer should provide any additional information in its general purpose financial statements to show what its performance would have been if it had acquired the assets and assumed the liabilities of the acquiree at their existing carrying amounts, instead of fair values, at the date of acquisition.

I am therefore of the view that there is no urgent need for the IASB to introduce new requirements to modify the existing requirements for the acquirer to apply fair value accounting at the date of acquisition.

Q2 Which of the alternatives illustrated in the paper do you support? What is your reasoning?

The DP sets out four alternatives and I will comment on each of them below.

(a) Presenting the impact of the step-ups in a separate line item of the statement of comprehensive income

The DP considers the option of presenting separately the incremental cost (from the accounting mechanics of reversing of the step-up) from the "normal" cost of sales, either as an item immediately next to the cost of sales or as a component of "Restructuring" expenses.

The problem with this presentation is that an inexperienced user of the financial information might think that on a normalised basis, the acquirer's profit margin would improve by the quantum of the separately presented step-up cost. This can be misleading because the step-up cost includes not only the profit margin retained by the seller of the business but also other recurring cost and expenses of the acquiree which is now a member of the acquirer's group. In a normalised year, the acquirer's profit margin will improve by a quantum smaller than that indicated by the step-up cost.

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

If the acquirer could offset the cost of semi-finished products against the revenue, the profit margin derived from its own activities as a percentage of net revenue would be higher. The general principle of this adjustment, it seems to me, is to exclude the component of the revenue (together with the same amount of cost of sales) for which the acquirer of the business derives no profit margin (as the profit margin is retained by the seller). This concept is difficult to apply as the acquirer would price its finished product in such a way that it recovers not only the cost of semi-finished goods in full but also some related cost components shown below the gross profit line.

Also, outside the scope of business combination, if an entity starts to outsource some production activities to a third party such that its purchases comprise largely semi-finished products instead of raw materials, we may be reluctant to think that its income statement deserves any adjustment to reflect an improved rate of profit margin. If this entity acquires the third party through which some semi-finished products are brought into the acquirer's group, one may think that this is not so different from its usual practice of purchasing semi-finished products from that third party and therefore it does not warrant any offsetting adjustment.

In my view, this is an interesting concept that is not easy to apply in practice.

(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

I agree with EFRAG's rejection of this approach as there is no reasonable argument for an acquirer to record a component of its actual cost of sales within OCI.

(d) Disclosing sufficient information to enable users to make the adjustment

While there is no conceptual merit for the acquirer to present in its general purpose financial statements what its performance would have been if it had acquired the assets and assumed the liabilities of the acquiree at their existing carrying amounts, instead of fair values, at the date of acquisition, there may be a case for providing some relevant supplementary information to enable users to perform more meaningful financial analysis, especially for the transitional years in which the acquirer's results are complicated by the acquisition of business.

In my view, additional disclosure is a more viable approach although further study has to be conducted to derive some general principle for disclosure. In particular, we should be mindful of the pitfall I mentioned in (a) above as the user may use the disclosed information simplistically to make inappropriate adjustments.

(e) Voluntary provision of information

I support the suggestion that pending the development of a definitive standard for the disclosure of additional information, which can take a number of years, the IASB could encourage entities to provide additional information on a voluntary basis.

I hope my comments are useful. If you require any clarification, please do not hesitate to let me know.

Yours faithfully,

Kim C Chua