

EFRAG Short Discussion Series
PRESENTATION OF THE REVERSAL
OF ACQUISITION 'STEP-UPS'



SEPT
2014



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We welcome views on any of the points addressed in this paper. Specific questions are given at the end of the document. These comments should be sent by email to commentletters@efrag.org or by post to:

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So as to arrive no later than 31 December 2014.

All comments will be placed on the public record unless confidentiality is requested.

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- 1 The fundamental measurement principle in IFRS 3 *Business Combinations* is to measure the identifiable assets acquired and liabilities assumed at their acquisition-date fair value (with only a few exceptions). This may result in upward adjustments on the carrying amount in the acquiree's financial statements, which are commonly referred to as 'step-ups'.
- 2 In particular:
 - (a) In the case of inventory acquired at a retail outlet, paragraph B35 of IFRS 13 *Fair Value Measurement* indicates that the fair value measurement reflects the price that would be received to sell the inventory to another retailer that would complete the requisite selling effort; and
 - (b) While there is no explicit mention in IFRS 13 of customer-related intangible assets acquired in a business combination, these are typically valued under an income approach, which involves discounting the expected future cash flows.
- 3 Assets that are stepped-up on acquisition include both recognised and unrecognised items of the acquiree. Some of these assets are expected to be recovered through use over the long-term; other assets such as manufactured inventory or order backlog are realised through sale in the operating cycle. In the financial sector, adjustments are commonly made to loans and receivables (as well as liabilities).

The case for fair value in IFRS 3



- 4 Paragraphs BC199 to BC204 of IFRS 3 explain that the IASB chose an acquisition-date fair value measurement because a combination of historic and current values would be confusing and useless. Amounts that relate to transactions and events occurring before the acquisition date are not relevant to users. Before IFRS 3 became effective, allocation of the purchase price resulted in recognising acquired assets and liabilities at a mixture of current exchange prices and historic values, especially for acquisitions occurring in steps.
- 5 The premise in IFRS 3 is that the consideration paid should incorporate the fair value of the acquiree's net assets. A rational seller would not accept less than the fair value for any of its assets, when the transaction is at arm's length. If the consideration does not incorporate the fair value of an asset, the seller is better off keeping that asset out of the business combination, and selling it separately. Therefore, the acquirer is expected to pay the fair value for all the assets and cannot obtain a normal margin when it disposes of it.
- 6 Also, from a stewardship perspective, it may be argued that management of the acquirer should not take credit for the economic performance (i.e. successful sales effort) of the predecessor management. 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. This incentive would be compounded by the fact that, if the acquirer allocates a value lower than fair value to the identifiable assets, it results in a higher goodwill which is not depreciated under IFRS 3.
- 7 The IASB has started a post implementation review of IFRS 3. EFRAG representatives, in partnership with some European National Standard Setters have held or participated in several outreach activities with users and preparers to identify implementation difficulties and understand the overall effects of IFRS 3 and related Standards. Two feedback statements summarising the views of the participants are available on the EFRAG website.

Is there an issue with step-ups?



- 8 Stepping-up acquired assets affects future operating costs in the consolidated financial statements. If a stepped-up asset, such as manufactured inventory is subsequently sold, the cost of sales is higher than if the asset had been recognised at the cost in the financial statements of the acquiree. In the financial sector, the adjustment on loans and receivables will lead to an adjusted effective interest rate which may differ from the effective interest rate on similar instruments held by the acquirer.
- 9 In the post-acquisition accounts of the acquirer, this results in the recognition of a lower margin from the acquired business. Some users have expressed dissatisfaction with this¹ because in normal conditions – that is, assuming that the acquired business will continue to operate in the same way as before the acquisition - they would use the margin from the post-acquisition account to predict how the acquired business will contribute to the future performance and cash flows of the Group on a continuing basis.
- 10 The reversal of the step-ups introduces a component that will not recur in the future operations of the acquiree. As a consequence, some argue that until the assets recognised at acquisition date have been disposed of, activities are not based on ‘normal’ prices and the acquirer does not recognise a ‘normal’ selling margin from the acquired business (or in the financial sector a ‘normal’ interest income).
- 11 It should however be noted that the reversal of the step-ups is only one element that may detract from the users’ ability to use the acquiree’s pre-acquisition performance as an indication for future performance. Isolating the reversal of the step-up would provide useful information only if the acquirer does not impact otherwise production costs and selling prices of the acquired business by changing, for instance, the production process, the supply chain or the marketing strategy.
- 12 For completeness, it is useful to note that during EFRAG’s outreach on the post-implementation review of IFRS 3, preparers also expressed similar concerns²:
 - (a) Some respondents questioned the recognition of inventory at fair value because a major part of the gross profit was added to the inventory values and led to lower future margins; and
 - (b) Some respondents supported a more entity-based perspective to measure acquired assets in a business combination, rather than the “hypothetical” market participant approach under IFRS 13.

¹ The point was explicitly raised during the initial meeting on the post-implementation review between EFFAS and EFRAG in December 2013.

² The full feedback statement on the outreach with preparers is available at <http://www.efrag.org/Front/p296-1-272/IFRS-3---Post-implementation-Review.aspx>

Is this only an issue in a business combination?

- 13 Business combination are not the only transaction or circumstances that may generate a margin not consistent with the margin from the entity's recurring activities. An entity whose business model is to manufacture and sell finished products may on occasions trade goods purchased from a third party. In that case, the margin earned on this specific transaction will differ from the 'normal' margin earned from the recurring activities, not unlike what happens when the entity sells inventory stepped-up in a business combination.
- 14 It could then be argued that, if there is a need to provide information on the impact of step-ups in a business combination, then the same applies to all transactions that will generate a margin that is inconsistent compared to the 'normal' margin. This would be the case for any transaction that does not fit in the entity's business model or that are affected by specific market conditions (such as bargain purchase prices or unusual foreign exchange rates). This would require an entity to assess what the benchmark margin is, when the deviation becomes relevant and the information material. Some could argue that this is already required in accordance with paragraph 85 of IAS 1 *Presentation of Financial Statements* – paragraph 86 further explains that additional line items may be required to understand the financial performance because transactions and other events differ in frequency, potential for gain or loss and predictability.
- 15 However, there is a difference between other transactions with a potential to distort the assessment of future performance and a business combination. The amount of the step-up does not derive from a price explicitly negotiated between the parties, but is the result of an allocation process performed by the entity. Possibly, the inherent limitations in reliability of the allocation process explains why users claim to need more information in this circumstance.
- 16 Moreover, business combinations may have a more pervasive impact on the acquiring Group compared to one-off purchase or sale transactions, or may be perceived as transactions that occur less frequently and at irregular intervals – and therefore, that are more likely to modify previous trends.
- 17 For these reasons, this paper will focus on providing information on step-ups resulting from a business combination. This does not exclude that the analysis and the alternatives explored may be applied to other transactions.

What assets should be considered?



- 18 As mentioned above, all identified assets and liabilities are measured to fair value at acquisition date in a business combination. Step-ups on assets recovered through use results in future higher depreciation charges, while step-ups on assets recovered through sale result in future higher cost of sales.
- 19 Before exploring how to provide information on the impact of step-ups on future margins, it is necessary to identify the step-ups that create the alleged distortion. The step-up from carrying amounts to fair value could be attributed to:
 - (a) The recognition of items (such as customer relationships) that an entity would usually expense immediately in its ordinary activities;
 - (b) The profit margin attributable to the activity performed by the acquiree until the date the acquisition, including the commercial effort to obtain the contract; or
 - (c) Changes in the prices of production input, like raw materials.
- 20 The components of a step-up that impact profit or loss as a direct result of the acquisition rather than separate external events are the first and the second. This is the information that is of value to users for an estimate of future transactions. However, disaggregating the components of the step-ups may be complex. So it seems advisable aiming at identifying those assets for which the first and second component are likely to be the most significant. This is the case for inventories, work in progress and some intangible assets that are normally recognised only in a business combination. For the latter, some believe that their amortisation in the period following the business acquisition represents a duplication of ongoing commercial costs that the entity incurs in its ordinary activities and expenses as incurred.
- 21 For items such as property, plant and equipment or acquired debt, the step-up principally captures changes in market prices and rates; fair value at acquisition may in fact be more predictive than historical cost information. For instance, the current value of acquired debt predicts the interest cost of future borrowings.
- 22 Moreover, some argue that users are less concerned about the step-up on assets recovered through use (i.e., property, plant and equipment) because they assess performance on metrics such as EBITDA which are not affected by the increased depreciation charge.

How this paper addresses the issue

- 23 There are different ways in which the information on the reversal of the step-ups could be provided (for clarity, ‘presentation’ implies a separate display in the primary statement and ‘disclosure’ implies explanation in the notes):
- (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;
 - (b) Offsetting the revenue and cost of goods sold for the performance completed by the acquiree until the acquisition date;
 - (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;
 - (d) Disclosing the information necessary to users interested to make the adjustment;
or
 - (e) Disclosing adjusted non-IFRS measures.
- 24 Provision of information would be subject to the usual assessment of relevance. As explained above, presenting or disclosing an adjusted margin would be relevant to the extent that no significant changes were expected in the way the acquired business is run. Also, an entity would have to assess if the amount of the step-up is material.
- 25 As an alternative, as discussed in paragraph 54 below, the Standard Setter could decide that an entity may elect, but is not required to, disclose the information.



PRESENTING THE IMPACT OF THE STEP-UPS IN A SEPARATE LINE ITEM OF THE STATEMENT OF COMPREHENSIVE INCOME

- 26 One way to display the information would be to disaggregate the cost of the acquired inventory sold in two separate lines in the statement of profit or loss – one for the ‘normal’ production cost and one for the step-up.
- 27 IAS 1 prescribes a minimum content and requires presenting additional line items, headings and sub-totals when such presentation is relevant to an understanding of the entity’s financial performance.
- 28 This approach would raise two questions:
- (a) Is it permissible to disaggregate the ‘changes in inventory’ in an income statement by nature; or a ‘cost of sales’ by function, and display separately two amounts?
 - (b) If so, where is it acceptable to present the reversal of the step-ups, and how can it be labelled?
- 29 Under the current version of IAS 1 it seems possible to disaggregate the amount. Paragraph 101 allows disaggregation of expenses to highlight components that may differ in terms of frequency, potential for gain or loss or predictability. Step-ups are less recurring in nature and occur only following a business combination.
- 30 The answer to the second question under the current version of the Standard is less clear. Paragraph BC55 of IAS 1 notes that the Standard omits a previously existing requirement to disclose the results of operating activities as a line item. The IASB did not want to require disclosure of an item that is not defined, and ‘operating activities’ is not a defined term. However, paragraph 56 of the Standard states that it would be inappropriate to exclude items clearly related to operations (such as inventory write-downs) only because they occur irregularly or infrequently. It should be noted that step-ups arising from a specific business combination may occur over more than one reporting period.
- 31 So, if the items are presented separately, it may be argued that under the current IAS 1 they must be included within the same sub-total used to portray the result of its operating activities. However, it is debatable whether the reversal of the step-up should be presented immediately next to the cost of sales.
- 32 Recently, a European enforcer ruled against a preparer that had presented the step-up on inventories acquired in a business combination as a non-recurring cost within operating income upon disposal.

33 The enforcer noted that:

- (a) paragraph 38 of IAS 2 *Inventories* defines cost of sales, as those costs previously included in the measurement of inventory that has now been sold;
- (b) paragraph 18 of IFRS 3 requires an acquirer to measure identifiable assets acquired at their acquisition-date fair values.

34 The enforcer concluded that it would be adequate to highlight the particular nature of the expense through additional disclosure within cost of sales.

35 Some entities have presented the two amounts within the same sub-total heading but not in two consecutive lines with a structure like this:

| |
|----------------------------------|
| Sales |
| Cost of goods sold |
| Gross profit |
| Marketing and distribution |
| Research and development |
| General and administrative |
| Restructuring |
| Divestment gains/losses |
| Other general and administrative |
| Operating income |

36 In this case, the notes specify that 'Restructuring' includes 'acquisition and related integration costs', which in turn includes reversal of inventory step-ups from prior acquisitions as well as amortisation of reacquired rights.

37 In July 2010, the IASB published a staff draft of a new Standard on Financial Statements Presentation. Paragraph 155 of that document would have required an entity to present separately a material event or transaction that is unusual or occurs infrequently. Such a wording would more clearly require entities to isolate the reversal of the step-ups in a separate line (although some may question if reversal of the step-ups qualify as 'infrequent' when a reporting entity routinely acquires other businesses).

OFFSETTING THE REVENUE AND COST OF GOODS SOLD FOR THE PERFORMANCE COMPLETED BY THE ACQUIREE UNTIL THE ACQUISITION DATE

- 38 The reversal of step-ups affects the operating margin because the profit or loss of the acquirer shows separately the gross revenue from the sale of the acquired inventory and the cost of goods sold inclusive of the step-ups.
- 39 If the revenue and the cost of goods sold were offset, the acquirer would not recognise any margin (to the extent of the activity performed by the acquiree before the acquisition). In this way, the net margin in percentage terms would not be affected by the reversal of the step-ups.
- 40 IFRS 15 *Revenue from Contracts with Customers* defines revenue and income as follows:
- (a) Revenue is income arising in the course of an entity's ordinary activities;
 - (b) Income is increases in economic benefits during the accounting period in the form of inflows or enhancement of assets...that result in an increase of equity, other than those relating to contributions from equity participants.
- 41 In a way, it could be argued that when the acquired inventory is sold, not all the selling price should be presented as a revenue of the acquirer but only the portion of the price that corresponds to the activity performed after the business combination (and not the activity performed by the seller before the business combination).

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

- 42 Another alternative would be to display the reversal in Other Comprehensive Income (OCI). The role of OCI is being debated in the Conceptual Framework review. The Discussion Paper on Conceptual Framework does not equate financial performance with either 'total comprehensive income' or 'profit or loss'. Some believe that it could be useful to have some measure of 'core' result that express the entity's performance from ordinary activities.
- 43 Paragraph 8.20 of the Discussion Paper lists arguments in favour of including profit or loss as a total or subtotal. One argument is that profit or loss excludes re-measurement gains or losses that are potentially less predictive of future net cash inflows because they are not likely to persist. By analogy, it could be argued that the acquisition date fair value provides an appropriate measurement of the acquired assets but is not relevant to depict the entity's long-term performance.

- 44 EFRAG rejects this view. Paragraphs 10A and 81A of IAS 1 require an entity to present separately profit or loss and total OCI for the period. If an entity displayed the reversal of the step-up in OCI, then profit or loss would not include that item. So EFRAG would not support the recognition of the reversal of step-ups in OCI, because it would overstate earnings for the period.
- 45 Also, this would be a very different use of OCI compared to items currently charged to OCI, such as actuarial differences. Changes in OCI are normally originated by re-measurement of assets and liabilities, while in this case, the change in OCI would arise when the asset is derecognised. Also, there would be no clear basis to recycle the item to profit or loss at a future date; it could only be transferred within equity (if considered necessary).

DISCLOSING SUFFICIENT INFORMATION TO ENABLE USERS TO MAKE THE ADJUSTMENT

- 46 Some object to a disaggregation on the face on the statement of comprehensive income. If fair value is deemed to be the appropriate measurement basis for assets acquired in a business combination, they see no reason for a separate presentation of the reversal of the step-up. In their view, any disclosure of the impact of the step-up should be in the notes.
- 47 Some entities provide adjusted measures that are characterised as non-IFRS. For instance, one entity reports non-IFRS revenue which is adjusted (among other things) from 'the IFRS revenue by including the full amount of support revenue, cloud subscriptions revenue and other non-recurring revenue that the Group was not allowed to recognise due to the fair value accounting for the contracts in effect at the time of acquisitions'.
- 48 IFRS 3 has extensive disclosure requirements that focus on two objectives:
- (a) Provide information on the nature and financial effect of a business combination that occurred in the reporting period;
 - (b) Provide information on adjustments that arise from business combinations that occurred in prior periods.
- 49 The way in which the Standard articulates the first objective is that it requires disclosure of the revenue and profit and loss of the acquiree since the acquisition date; and of revenue and profit or loss of the combined entity as if the combination had occurred at the beginning of the period.

- 50 The requirement in B64(q)(ii) could be seen as a way to depict how the acquisition is likely to affect post-combination revenue and result of the Group. However, the reference in paragraph 59 of IFRS 3 is to business combinations that occurred during the current reporting period or after the end of it, but before the financial statements are authorised for issue; the reversal of the step-up may refer instead to combinations occurred in prior periods.
- 51 Moreover, the Standard does not include guidance on what basis this information should be prepared and whether this should be a simple aggregation or whether it should include adjustments. So the disclosure cannot be interpreted as requiring pro-forma information.
- 52 Rather than prescribing pro-forma information, the Standard could require disclosure of information that provides users with the data necessary to perform their own calculation, if they are interested in 'netting' the effect of the step-ups.
- 53 This could be achieved by any of the following disclosure:
- (a) the amount of step-ups reversed in the current period and the residual step-up still included in the inventory at year end;
 - (b) the carrying amount in the acquiree's separate financial statements and the step-up adjustment separately by class of asset and liability; and the residual amount of the assets and liabilities originally acquired; and
 - (c) revenue and profit or loss of the combined entity as though the acquirer carried forward the carrying amounts in the acquiree's statements. To reduce the burden entities could be allowed to include the information only for individually material combinations.

VOLUNTARY PROVISION OF INFORMATION

- 54 Some argue that there should not be a requirement to provide this information. It may be arbitrary to require the information only for some items (for instance, for inventory but not for customer relationships) and any distinguishing criterion could be questioned. It is already possible to provide the information if the entity believes it to be relevant and material and that this information fits into the general disclosure objective in paragraph 59 of IFRS 3.

- 55 Another argument against a specific disclosure requirement is that producing the information requires keeping a second set of figures, and is therefore costly. However, in most cases, the acquirer should be able to derive the information from the acquiree's separate financial statements, if the step-up has not been pushed-down. This is rarely the case because step-ups are often not relevant for tax purposes. Furthermore, it is likely that this information would be produced for internal purposes even if the acquiree was not legally obliged to prepare separate accounts.
- 56 Some may object that entities are already allowed to provide this information on a voluntary basis, if it is not implicitly required by the general disclosure objective of IAS 1 and IFRS 3. However, if users complain about the lack of information, it shows that some entities do not provide the information. The IASB could encourage entities to consider a voluntary disclosure by mentioning somewhere in the Standard that some users find this information useful.
- 57 In case entities are allowed but not required to provide the information, they should also be allowed to choose the way of presenting or disclosing it.

Practical problems



- 58 Some also note that the amount of the step-up that should be presented or disclosed is unclear. The paper assumes that the step-up is the difference between the fair value at acquisition (determined in accordance with IFRS 13) and the carrying amount in the acquiree's separate financial statements. However, some note that this amount may not be relevant, if for example the carrying amounts in the acquiree's statements do not comply with IFRSs. While accepting the validity of the argument, it should be noted that under most GAAPs, the measurement of inventories in the acquiree's financial statements is the lower of cost and recoverable amount. Entities could also be encouraged to determine a carrying amount in accordance with IFRSs, when it is practicable to do so.
- 59 Another practical issue may arise if the acquiree is a group. The carrying amounts may be different in the acquiree's consolidated financial statements and the financial statements of the entity holding the assets, because of intragroup transfers or if the entity holding the assets had been recently acquired. In these cases, it is unclear which are the carrying amounts that should be referred in presenting (or disclosing) the step-up.

Questions to constituents

We would welcome views, sent to commentletters@efrag.org by 31 December 2014, on any of the points addressed in this paper. In particular:

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



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