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EFRAG
35 Square de Meeûs
B-1000 Brussels
Belgium

Response to discussion paper:
Presentation of the Reversal of Acquisition 'Step-Ups'

The Financial Reporting and Analysis Committee (FRAC) of the CFA Society of the UK (CFA UK) welcomes the opportunity to respond to EFRAG's discussion paper on the reversal of acquisition 'step-ups'.

CFA UK represents more than 10,000 investment professionals working across the financial sector including asset managers, buy-side analysts, sell-side analysts and credit rating analysts, among others. For advocacy purposes in the field of financial reporting, these members are represented by the FRAC.

Acquisitions are an important subject for investors as they often involve the creation or destruction of significant value. Investors usually track the financial performance of an acquired business very closely following its acquisition, both to check that the acquisition is performing in line with expectations and to measure the underlying, organic growth of the acquirer.

Under IFRS, the inventories and work-in-progress of an acquiree are written up on acquisition to reflect the manufacturing and/or commercial efforts that the acquiree has already expended. Consequently, as the associated revenue is recognised, the acquirer will report lower gross margins over the "inventory workdown" period than would have been achieved by the acquiree had it continued as a stand-alone entity.

Many analysts and investors have reservations about the usefulness of writing up acquired inventory to fair value and thus usually ignore these adjustments from their measure of underlying earnings. They do not view the reduced profitability in the initial period following the acquisition as recurring and hence it makes it more difficult to determine a normalised profit level.

Investors would favour the disclosure of the impact of acquisition step-ups on revenue and gross profit so that they can make adjustments to their own measure of underlying earnings. Many companies already do this either as a note to the financial statements or as a full non-IFRS income statement with the relevant adjustments explained in detail. Additional guidance from the IASB would be helpful to ensure that all companies feel confident about the appropriate way to make this information transparent, and to encourage consistency.



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?

We believe the IASB should introduce new requirements on the disclosure of the effect of acquisition step-ups. We believe that there will be a need for guidance/illustrative examples showing how this information is best disclosed to ensure consistency and comparability. Most companies are keen to tell investors of the impact of step-ups on their financials so that investors can back them out (i.e. exclude them) to arrive at a measure of recurring and normalised earnings. There is a risk that these step-up adjustments are only disclosed verbally (e.g. in an earnings call) if companies are worried that disclosing them in their financial statements might lead to a breach of the accounting rules. In the interest of transparency, it would be better if step-up adjustments were clearly and consistently disclosed, preferably in the notes to the financial statements.

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

Investors would favour clear disclosure of the impact of acquisition step ups on operating profit. This could be presented as a note to the financial statements or a in a non-IFRS income statement with the relevant adjustments explained in detail.

(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;

Investors want to know the exact amount of the step-up during each reporting period and would not want the figure to be subsumed into another category such as restructuring costs due to the acquisition. Therefore, any label for the separate line item would need to clearly state that it is the step up related to X asset class and that it relates to a business combination. Investors would like to make their own assessment of the company's underlying performance, adding back step-ups and/or restructuring or other costs as they see fit.

We favour presenting the impact of step-ups in a note to the financial statements rather than as a line item in the income statement.

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

We do not support this alternative because it reduces transparency about the effect of the acquisition. Reducing the revenue recognised from an acquisition would reduce the comparability of the performance of the acquired business pre and post acquisition. Investors are keen to understand both the performance of a newly acquired business and the acquirer's underlying organic performance. To eliminate the revenue associated with the work in progress of the acquiree in this way would hinder investors' ability to measure and track performance.

(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 would require a much more fundamental consideration of what OCI is. At present these numbers are largely ignored by investors. As such there is a risk that



reporting step-ups in OCI might in effect obscure them. We repeat our call for a more fundamental project to consider performance reporting, which we expect would need to include a reassessment of the role of OCI.

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

Investors would like to know what the revenues and gross profit of the combined entity would be without the step-ups (i.e. as though the acquirer carried forward the carrying amounts in the acquiree's statements). We think this should be presented as a note disclosure enabling investors to calculate their own revenue and profit measures.

(e) Voluntary provision of information - disclosing adjusted non-IFRS measures.

In our experience, companies are not shy about disclosing non-IFRS measures and a requirement to produce these would not appear to be necessary. However, some companies may be reluctant to disclose adjustments related to acquisition step-ups for fear of breaching accounting rules. As such, clear guidance for companies for how they should disclose these step-ups appears necessary.

We look forward to discussing the issues raised in this response.

Yours sincerely,



Paul Lee
Co-chair, Financial Reporting and Analysis Committee
CFA Society of the UK



Marietta Miemietz
Co-chair, Financial Reporting and Analysis Committee
CFA Society of the UK



Will Goodhart,
Chief Executive
CFA Society of the UK



James Crawshaw, CFA, ASIP
Financial Analysis and Accounting Adviser
CFA Society of the UK

About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) represents the interests of more than 10,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has more than 100,000 members in 140 countries, of which more than 90,000 hold the Chartered Financial Analyst (CFA) designation.