Project **New items for initial consideration**

Topic **IFRS 3 Business Combinations—Definition of a business**

Objective and introduction

1. The objective of this Agenda Paper is to inform the IFRS Interpretations Committee (the Committee) about an agenda item request that the staff has received and to give an update on the staff's research and analysis to date on this issue. In addition, the staff are seeking to obtain preliminary views and guidance from the Committee to assist them in their analysis.

2. This Agenda Paper includes:

   (a) background information on the issue;

   (b) a staff analysis to date;

   (c) staff recommendations on the next steps; and

   (d) questions for the Committee.

Background information

The issue

3. IFRS 3 *Business Combinations* does not address the acquisition of a single asset. It gives guidance on the accounting for the acquisition of a business (see paragraph 3 of IFRS 3).

4. Appendix A of IFRS 3 defines a business as 'an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.'

5. Paragraph B7 of IFRS 3 illustrates this definition further by explaining that 'a business consists of inputs and processes applied to those inputs that have the ability to create outputs'.

6. Deliberating the application of that guidance, the submitter asks whether an asset with relatively simple associated processes meets the definition of a business in accordance with IFRS 3. In particular, we think that it raises the question of whether the acquisition of a contract to provide services alongside the acquisition of an asset constitutes a business combination.

7. This issue is not explicitly addressed in IFRS 3 and we are told by the submitter that diversity in practice is emerging because of this lack of guidance as far as acquisitions of a single investment property with lease agreements with multiple tenants over varying periods and associated processes, such as cleaning, maintenance and administrative services such as rent collection, are concerned. While some consider the acquisition of such an investment property together with an obligation to render the services to be a business combination as defined in IFRS 3, others believe that it is the acquisition of only a (single) investment property. We understand that preparers find it difficult to apply the necessary judgement.

8. Applying IFRS 3 is especially relevant for the recognition of goodwill, if any, for the treatment of transaction costs, and for the requirements for contingent consideration and deferred taxes.

9. We note that the consequence of recognising deferred taxes might become less of an issue in some jurisdictions by the amendments to IAS 12 *Deferred Tax: Recovery of Underlying Assets* issued December 2010. Relevant jurisdictions in this context are jurisdictions where the applicable tax rate is much lower if the carrying of the investment property is recovered through sale and not through use (see paragraphs 51C and 51D of IAS 12 reproduced in Appendix A to the this paper). However, the amendment to IAS 12 will not have this effect in all jurisdictions and the underlying question raised in the submission will remain.

Summary analysis presented in the submission

10. The submitter identified two divergent views on whether the acquisition of a single investment property with lease agreements with multiple tenants over varying periods and associated processes represents a business as defined in IFRS 3 or not:

(a) **View 1 *It is a business*:** the acquirer applies IFRS 3 to the acquisition of such an investment property. Proponents of the view believe that the existence of outputs in the form of revenue implies that there must be inputs and processes that give rise to a business as defined in IFRS 3. Accordingly, they consider processes that provide services to the tenants, such as cleaning, maintenance and administrative services such as rent collection to be relevant processes for the assessment of whether it constitutes a business or not. Furthermore, they emphasise that it is not even necessary that the vendor should transfer these processes to the acquirer in the transaction for it to be a business combination. If the acquirer is not a real estate company that integrates the acquired property into its existing processes, these services can readily be obtained from third-party managers.

(b) **View 2 *It is a not business*:** the acquirer accounts for it as the acquisition of a single asset. Proponents of this view believe that 'significant' processes are required for a business as defined in IFRS 3. Services such as cleaning or maintenance are, they believe, not significant processes, ie processes that create outputs as required by paragraph B7 of IFRS 3. They consider these services to be, instead, closer to the ancillary services described in IAS 40 or the administrative services specified in the last sentence of paragraph B7(b) of IFRS 3. Thus it is the investment property itself as the key input that generates the outputs and not the associated processes.

11. The submitter states that the issue occurs frequently and believes that it is starting to result in divergent treatments in practice.

12. The submitter understands that prevailing practice under US GAAP would support view 1. The submitter highlights that US GAAP, by comparison with IFRS, does not have an investment property standard.

13. For ease of reference, the text of the submission is reproduced in Appendix C to this paper.

Current IFRS literature

14. We reproduce for ease of reference in Appendix A the paragraphs from the standards that we used to perform our analysis.

US GAAP comparison

15. The definition of a business in the master glossary to the FASB's Accounting Standards Codification (ASC) and the additional guidance on what a business consists of, presented in paragraphs 805-10-55-4 through 55-9 of the FASB's Accounting Standards Codification (ASC), are, for ease of reference, reproduced in Appendix B.

16. This guidance is nearly identical with the one in Appendix A and paragraphs B7-B12 of IFRS 3 (see paragraph BC18 of IFRS 3).

17. We understand from discussions with the submitter that prevalent practice under US GAAP concludes, in applying the guidance above, that a single investment property with multiple tenants and associated processes such as cleaning and maintenance services constitutes a business and that the acquisition of such an asset with lease contracts and associated processes is accounted for as a business combination.

Staff analysis to date

Preliminary staff view

Rebuttable presumption

18. Paragraph B7 of IFRS 3 gives a broad description of a 'process'. It considers 'any system, standard, protocol, convention or rule that when applied to an input or inputs, creates or has the ability to create outputs' a process. Given that every ongoing provision of service requires the application of some kind of 'process', we think that a contract to provide ongoing services related to an asset creates the rebuttable presumption that there are processes that give rise, together with the asset, to a business.

Part of integrated set of activities and assets

19. We think that the services provided must relate to the asset. Otherwise, the contract and the asset are not an **integrated set of activities and assets** as required by the definition of a 'business' in Appendix A of IFRS 3.

20. IFRS 3 does not provide further explicit specifications for a process to qualify as one that could give rise to a business. Consequently, we think that acquisitions of a single investment property with lease agreements with multiple tenants over varying periods and associated processes, such as cleaning and maintenance, are business combinations in principle.

21. In the example given in the submission, the inputs acquired include:

    (a) the investment property; and

    (b) existing lease agreements with multiple tenants over varying period.

22. The processes acquired include:

    (a) cleaning services; and

    (b) maintenance service.

    We understand that these are processes that generate revenue. However, the administrative service of rent collection does not create outputs. It only ensures that the owner of the investment property receives the economic benefits in the form of rental revenue. This classifies it as an administrative service, which is addressed in the last sentence of paragraph B7(b) of IFRS 3.

23. In our opinion, the assessment that a customer would obtain the service from another external provider if the owner of the asset didn't render it is an indicator for the service/process being integrated with the asset.

24. However, we would not make the converse argument, ie automatically exclude any service rendered by the owner of the assets from the integrated set of activities and assets that does not meet that test. A service that is actually rendered by the owner of the asset for money and that is clearly related to the asset suggests to be part of the integrated set of activities and assets, no matter whether the customers would obtain the service elsewhere if the owner of the asset didn't render it. Consider for example a landlord that renders security

services beyond burglar alarm (ie inspection patrols) to tenants of apartments located in a peaceful area on the countryside. If the tenants pay for these services just to get one of these apartments we would consider the patrol inspection services rendered by the landlord to be part of the integrated set of activities and assets, even if none of tenants would obtain that service from an external provider.

25. This leads for the acquirer of an asset in principle to a business combination, if the acquirer incurs the obligation to continue the service related to the assets. This presumption holds according to paragraph B8 of IFRS 3 if the acquirer of the asset does not adopt the process of the vendor to deliver the service but uses its own existing processes.

Insignificant service

26. IFRS 3 does not explicitly require that the services delivered or the processes for delivering the services must meet specific significance levels.

27. Notwithstanding, we think that the services delivered and the processes to deliver the service should not be insignificant[1] compared to the customers' right to use the asset (ie the access to the asset) for concluding that there is a business as defined in IFRS 3.

28. Although IFRS 3 does not explicitly address the issue of significance, paragraph B7 of IFRS 3 explains that it is the application of processes to inputs in order to create outputs what makes a business and Appendix A of IFRS 3 describes a business as an integrated set of **activities** and assets. We think therefore that the activity/process must have at least some importance next to the asset to give rise to a business. We therefore think that the processes should be more than insignificant in order to lead to a conclusion that it is a business.

[1] We use the term ‚insignificant' as it is used elsewhere in IFRSs to distinguish certain levels of significance. If you think of other terms that better reflect the level of significance required for a process to lead to the conclusion that it is a business, we would welcome these.

Summary

29. As a result of our preliminary analysis of the guidance in IFRS 3 on what constitutes a business, we draw the following conclusions:

    (a) A contract to provide ongoing services related to an asset should be viewed as creating a rebuttable presumption that there are processes that give rise, together with the asset, to a business;

    (b) A service that the customer would obtain from an external supplier if the owner of the asset would not render it, is a indicator that the service is related to the asset in the sense that it forms part of an integrated set of activities and assets that constitutes a business;

    (c) The presumption that there is a business because of a contract to provide ongoing services related to an asset is rebutted, if the services delivered are insignificant compared to the customers' right to use the asset (ie the access to the asset).

30. We think these conclusions could be part of a clarification in IFRS 3 on what constitutes a business.

Outreach request

31. We have undertaken outreach to the National Standard Setters group to assess the Committee's agenda criteria, in particular whether:

    (a) The issue is widespread and has practical relevance.

    (b) The issue indicates that there are significant divergent interpretations (either emerging or existing in practice).

32. To address these criteria we sent out a request for information to the National Standard Setters group.

33. The questions asked to the National Standard Setters group were as follows:

1. What is the prevalence of this issue in practice in your experience? This is, how common or widespread within your jurisdiction is the acquisition of a single investment property with multiple tenants and associated processes like the ones described above in place?

> 2. What diversity in accounting for such transactions do you see in practice?
>
> If acquisitions of a single investment property with multiple tenants and associated processes such as cleaning, maintenance and administrative services such as rent collection in place are common in your jurisdiction, I would greatly appreciate it if you could also provide further information on the classification of such transactions according to paragraphs 3 and B5-B12 of IFRS 3 (2008):
>
> 3. Are they usually considered to be business combinations as defined in IFRS 3 (2008) or are they considered to be acquisitions of only a single asset, ie the investment property?
>
> 4. Are there criteria that entities use in your jurisdiction in exercising judgement to distinguish business combinations from acquisitions of a single asset so that they can use these criteria to exercise judgement consistently?
>
> 5. Are associated processes such as cleaning, maintenance and administrative services such as rent collection considered to be relevant in distinguishing business combinations from acquisitions of a single asset? If applicable, when are they considered relevant? Do you observe specific levels of significance?
>
> 6. Does it make a difference to the classification if the acquisition of a single investment property with multiple tenants and associated processes as described above in place is, from a legal perspective, an asset or a share deal?

34. The request was still outstanding as we were preparing this agenda paper. We will provide the Committee with an update of the results of this outreach at the July Committee meeting.

Staff recommendations

35. Our recommendation on the next steps depends on the results of the outreach:

    (a) if it turns out that the issue satisfies the criteria listed in paragraph 31 of this paper (which we expect to be the case when we finalise this agenda paper), we will propose that the Committee should add the issue to its agenda to identify how clarification or additional guidance could be developed to help distinguish a business combination from the acquisition of a single asset or a group of assets when an asset and contracts to render services related to the asset are acquired.

(b) if it turns out, however, that the issue does not satisfy the criteria listed in paragraph 31 of this paper, we will recommend that the Committee should not add the issue to its agenda.

36. Such a clarification might result in a difference between IFRSs and US GAAP although the Boards wanted a common definition of a business (see paragraph BC18 of IFRS 3). To avoid such a difference we would expect to liaise with the FASB staff when developing our proposals if the Committee decides to add the issue to its agenda.

37. If the Committee agrees with our recommendations, we would present a discussion of the outreach results together with either a draft tentative agenda decision, or a proposal for guidance or amendments, at the September Committee meeting.

Questions for the Interpretations Committee

Questions for the Committee
1. Does the Committee agree with our technical analysis in paragraphs 18-34? 2. In particular, does the Committee agree with each of our conclusions in paragraph 29? 3. Does the Committee agree with our recommendation in paragraph 35 and 36?

Appendix A—relevant IFRS literature

Extracts from IFRS 3 *Business Combinations*

3 **An entity shall determine whether a transaction or other event is a business combination by applying the definition in this IFRS, which requires that the assets acquired and liabilities assumed constitute a business. If the assets acquired are not a business, the reporting entity shall account for the transaction or other event as an asset acquisition. Paragraphs B5–B12 provide guidance on identifying a business combination and the definition of a business.**

Appendix A **business** An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

B7 A business consists of inputs and processes applied to those inputs that have the ability to create outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business. The three elements of a business are defined as follows:

(a) **Input:** Any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it. Examples include non-current assets (including intangible assets or rights to use non-current assets), intellectual property, the ability to obtain access to necessary materials or rights and employees.

(b) **Process:** Any system, standard, protocol, convention or rule that when applied to an input or inputs, creates or has the ability to create outputs. Examples include strategic management processes, operational processes and resource management processes. These processes typically are documented, but an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. (Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs.)

(c) **Output:** The result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

B8 To be capable of being conducted and managed for the purposes defined, an integrated set of activities and assets requires two essential elements—inputs and processes applied to those inputs, which together are or will be used to create outputs. However, a business need not include all of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes.

B9 The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities.

B10 An integrated set of activities and assets in the development stage might not have outputs. If not, the acquirer should consider other factors to determine whether the set is a business. Those factors include, but are not limited to, whether the set:

(a) has begun planned principal activities;

(b) has employees, intellectual property and other inputs and processes that could be applied to those inputs;

(c) is pursuing a plan to produce outputs; and

(d) will be able to obtain access to customers that will purchase the outputs.

Not all of those factors need to be present for a particular integrated set of activities and assets in the development stage to qualify as a business.

B11 Determining whether a particular set of assets and activities is a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Thus, in evaluating whether a particular set is a business, it is not relevant whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business.

B12 In the absence of evidence to the contrary, a particular set of assets and activities in which goodwill is present shall be presumed to be a business. However, a business need not have goodwill.

BC18 In the second phase of their business combinations projects, both boards considered the suitability of their existing definitions of a business in an attempt to develop an improved, common definition. To address the perceived deficiencies and misinterpretations, the boards modified their respective definitions of a business and clarified the related guidance. The more significant modifications, and the reasons for them, are: ...

Extracts from IAS 12 *Income Taxes* (amended 2010)

51C If a deferred tax liability or asset arises from investment property that is measured using the fair value model in IAS 40, there is a rebuttable presumption that the carrying amount of the investment property will be recovered through sale. Accordingly, unless the presumption is rebutted, the measurement of the deferred tax liability or deferred tax asset shall reflect the tax consequences of recovering the carrying amount of the investment property entirely through sale. This presumption is rebutted if the investment property is depreciable and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. If the presumption is rebutted, the requirements of paragraphs 51 and 51A shall be followed.

51D The rebuttable presumption in paragraph 51C also applies when a deferred tax liability or a deferred tax asset arises from measuring investment property in a business combination if the entity will use the fair value model when subsequently measuring that investment property.

Extracts from IAS 40 *Investment Property* (revised 2003)

11 In some cases, an entity provides ancillary services to the occupants of a property it holds. An entity treats such a property as investment property if the services are insignificant to the arrangement as a whole. An example is when the owner of an office building provides security and maintenance services to the lessees who occupy the building.

12 In other cases, the services provided are significant. For example, if an entity owns and manages a hotel, services provided to guests are significant to the arrangement as a whole. Therefore, an owner-managed hotel is owner-occupied property, rather than investment property.

13 It may be difficult to determine whether ancillary services are so significant that a property does not qualify as investment property. For example, the owner of a hotel sometimes transfers some responsibilities to third parties under a management contract. The terms of such contracts vary widely. At one end of the spectrum, the owner's position may, in substance, be that of a passive investor. At the other end of the spectrum, the owner may simply have outsourced day-to-day functions while retaining significant exposure to variation in the cash flows generated by the operations of the hotel.

Appendix B—relevant US GAAP literature

Extract from master glossary to the FASB's Accounting Standards Codification (ASC)

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

Paragraphs 805-10-55-4 through 55-9 of the FASB's Accounting Standards Condification (ASC)

55-4 A business consists of inputs and processes applied to those inputs that have the ability to create outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business. The three elements of a business are defined as follows:

(a) Input. Any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it. Examples include long-lived assets (including intangible assets or rights to use long-lived assets), intellectual property, the ability to obtain access to necessary materials or rights, and employees.

(b) Process. Any system, standard, protocol, convention, or rule that when applied to an input or inputs, creates or has the ability to create outputs. Examples include strategic management processes, operational processes, and resource management processes. These processes typically are documented, but an organized workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. Accounting, billing, payroll, and other administrative systems typically are not processes used to create outputs.

(c) Output. The result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

55-5 To be capable of being conducted and managed for the purposes defined, an integrated set of activities and assets requires two essential elements-inputs and processes applied to those inputs, which together are or will be used to create outputs. However, a business need not include all of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes.

55-6 The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes, and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities.

55-7 An integrated set of activities and assets in the development stage might not have outputs. If not, the acquirer should consider other factors to determine whether the set is a business. Those factors include, but are not limited to, whether the set:

a. Has begun planned principal activities

b. Has employees, intellectual property, and other inputs and processes that could be applied to those inputs

c. Is pursuing a plan to reduce outputs

d. Will be able to obtain access to customers that will purchase the outputs.

Not all of those factors need to be present for a particular integrated set of activities and assets in the development stage to qualify as a business.

55-8 Determining whether a particular set of assets and activities is a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Thus, in evaluating whether a particular set is a business, it is not relevant whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business.

55-9 In the absence of evidence to the contrary, a particular set of assets and activities in which goodwill is present shall be presumed to be a business. However, a business need not have goodwill.

Appendix C—Interpretations Committee potential agenda item request

C1. The staff received the following request. All information has been copied without modification, except for details that would identify the submitter of the request and details that are subject to confidentiality.

Issue:

C2. Is a single significant asset that may have some associated processes, such as an investment property, a business?

C3. The 2008 revisions to IFRS 3 and FAS 141 resulted in largely converged standards for accounting for business combinations under IFRS and US GAAP. The definition of a business is the same in both standards. The definition under IFRS was only changed slightly from the previous version of IFRS 3 but additional implementation guidance was added and the presumption that goodwill should be present was removed. There was a general expectation that there would be little change from existing practice in the determination of when a group of assets and activities would be considered a business under IFRS. (See Appendix A for definitions under the current and previous standards).

C4. A specific implementation question has arisen with regard to the treatment of single significant assets that have some associated processes, such as investment properties. An investment property with multiple tenants, by definition, generates cash flows largely independently of the other assets of an entity and this is what distinguishes it from owner-occupied property. The key input is the asset itself. Relatively simple processes are usually required for it to generate cash flows from rentals; often those processes are outsourced to third party suppliers. More sophisticated processes would be required to manage a group of investment properties. Concluding that a group of such assets with associated significant processes constitutes a business is less problematic and [the submitter] do[es] not observe significant diversity emerging.

C5. However, [the submitter] believe[s] that diversity is emerging in practice around the classification of a single significant asset, such as an investment property, as a business.

Current practice:

C6. There are two views currently as to whether the acquisition of a single investment property is an acquisition of a business.

C7. View 1: The acquisition of a single investment property with lease agreements with multiple tenants over varying periods represents a business combination. The existence of outputs (rental revenues) from the building implies there must be inputs and processes, therefore a business. For example, if there are tenants in a building this implies there will be processes to service those tenants, such as cleaning, maintenance and administrative services such as rent collection. If the buyer is a real estate investment company, the buyer likely has the necessary processes to operate the acquired investment property and integrate the acquired real estate with its existing processes. Further, in most cases, these processes can readily be obtained from third party managers.

C8. View 2: A single investment property, even if it has lease agreements with multiple tenants over varying periods may be an asset. The asset itself is the key input that generates outputs. The processes that are present or required in a single investment property are not the types of processes that create outputs. Rather the processes are closer to the ancillary services that are described in IAS 40. These processes or services are more in the nature of accounting, billing, payroll and other administrative systems that are described as ‘not processes used to create output’ in IFRS 3. Thus, a single investment property does not have any significant processes or services, and therefore is not a business.

Reasons for the IFRS IC / IASB to address the issue:

C9. The issue occurs frequently and [the submitter] believe[s] it is starting to result in divergent treatment in practice. [The submitter] understand[s] that prevailing practice under US GAAP would support View 1. US GAAP, in comparison to IFRS, does not have an investment property standard. The determination of what is a business and what is an investment property both require the exercise of judgement. However, [the submitter] believe[s] that additional guidance through an interpretation or improvement of IAS 40.7-13 or IFRS 3 could assist entities in making consistent judgements about the classification of investment properties and business.