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Project **Annual Improvements—2010-2012 cycle**

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

Introduction

1. In May 2011, the IFRS Interpretations Committee (the Committee) received a request seeking clarification on whether an asset with relatively simple processes associated with it meets the definition of a business in accordance with IFRS 3 *Business Combinations*. More specifically, the question is whether the acquisition of a single investment property, with lease agreements with multiple tenants over varying periods and with associated processes, such as cleaning, maintenance and administrative services such as rent collection, constitutes a business as defined in IFRS 3.

2. The Committee discussed the issue in the July 2011 meeting, with the July 2011 IFRIC *Update* reporting that:

> The Committee reviewed views received from outreach with the national standard-setters group and noted that the issue is widespread, that it has practical relevance and that there is significant divergence in practice.
>
> The Committee noted that the issue raises the question of whether there is any interaction between IAS 40 *Investment Property* and IFRS 3. It discussed services that are 'ancillary services' (as discussed in paragraphs 11-14 of IAS 40) that are not so significant as to disqualify a property from being an investment property but could nonetheless be considered a 'processes' (as discussed in paragraphs B7- B12 of IFRS 3) that could result in the acquired set of activities constituting a business.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRS Interpretations Committee or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*.

Interpretations are published only after the IFRS Interpretations Committee and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

The Committee directed the staff to perform further analysis on the interaction of IAS 40 and IFRS 3 and the characteristics of a business when investment property is acquired. The Committee asked the staff to consider the following questions:

a. Are IFRS 3 and IAS 40 mutually exclusive? (Ie can the acquisition of an investment property be a business combination?)

b. Would it be possible to develop guidance on how to determine if and when an obligation incurred in order to provide services in association with the acquisition of an asset would lead to a business combination?

The staff will present the results of this further work at the meeting in September 2011.

Purpose of the paper

3. This paper:

(a) gives a detailed summary of the results from the outreach to the National Standard Setters group;

(b) analyses the issue further within the context of IFRSs;

(c) assesses the issue against the Annual Improvements criteria;

(d) makes a recommendation that the Board should amend IFRS 3 through Annual Improvements; and

(e) asks whether the Committee agrees with our recommendation.

Outreach request

4. We sent out a request for information to the National Standard Setters Group in order to help 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).

5. 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?

6. At the July 2011 Committee meeting, we informed the Committee that we have received feedback from national standard-setters in 11 jurisdictions, of which 9 claim that the issue is widespread and has practical relevance and that there is significant diversity in practice, both within and between jurisdictions.

7. Since the Committee has discussed the issue at its July 2011 meeting, we have received a response from another national standard-setter, which noted that the issue is widespread in its jurisdiction but it didn't have the information available to say whether there is significant diversity in practice or not.

8. With respect to questions 3 – 6 of the outreach request, we have received the following observations from national standard-setters:

   (a) **Question 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?*

   Most national standard-setters acknowledge that delineating business combinations from the acquisition of a single asset with relatively simple associated processes requires significant judgement. However, an analysis of their responses reveals that there is significant diversity in practice, both within and between jurisdictions, concerning acquisitions of a single investment property with multiple tenants and with associated processes such as cleaning, maintenance and administrative services such as rent collection:

   (i) Significant diversity in practice between jurisdictions is particularly noted between North America on the one hand and continental Europe and Australia on the other hand. Practitioners in the US tend to consider the acquisition of a single investment property with multiple tenants and processes associated with it to be a business combination when applying the guidance in Appendix A and B7-B12 of IFRS 3 and the nearly identical guidance in paragraphs 805-10-55-4 through 55-9 of the *FASB Accounting Standards Codification®* (ASC). Practitioners in continental Europe and Australia however, generally conclude that it is the acquisition of a single asset, ie an investment property. Some national standard-setters ascribe this difference to the fact that US GAAP does not have an equivalent standard to IAS 40 *Investment Property*.

   (ii) However, significant diversity in practice does not only exist between jurisdictions. Several national standard-setters also noted significant diversity in practice within their own jurisdiction and emphasised that significant judgement is required in accounting for such transactions.

(b) **Question 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?*

Only some national standard-setters had information available about criteria used when exercising judgement to distinguish business combinations from acquisitions of a single asset. Very different criteria were provided, such as:

(i) The types of capabilities acquired with the property, ie property administration functions (cleaning, security, rent and service charge collection), property management functions (lease management, tenant strategy and marketing), property investment management functions (responsible for capital expenditure/allocation decisions and property acquisition and disposal) or central corporate functions (treasury, finance and tax). Most of the national standard-setters who noted the types of capabilities acquired as a relevant criterion also highlighted the acquisition of the strategic property management function as a criterion that typically classifies the acquisition as a business combination.

(ii) The extent of property administration services acquired. The more people that are involved on a full-time basis in the administration of the business, the more likely it is that the transaction is considered a business combination.

(iii) The 'knowledge' and 'skills' of the workforce acquired. Whereas the acquisition of an investment property together with services that are unique indicates the acquisition of a business combination, services that are easily replicable are not viewed as giving rise to a business combination.

(iv) Other national standard-setters made in a more general way reference to the number of properties acquired, number of tenants, length of lease terms, whether the services are rendered in-house or outsourced, whether all,

some or no service processes are acquired and whether the property represents entry into a new area.

(v) Finally some national standard-setters explained that it is considered relevant if the property acquired can easily be added to an existing portfolio of investment property of the acquirer with no or minimal need to employ those involved in the associated processes of the acquired investment property so far.

(c) **Question 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?*

One national standard-setter explained that practitioners have different views as to whether associated processes such as cleaning, maintenance and administrative services such as rent collection have to be acquired together with the investment property to qualify as a business combination. While some practitioners require the acquisition of such associated processes, others think that the inherent nature of the asset (ie an investment property, with multiple tenants, that has the ability to generate revenue) classifies it a business that is acquired, even if no processes are acquired.

Most national standard-setters observed that significance levels for processes are applied in one way or the other. However, none of them could give specific significance levels for property administration service as described above, if they are not completely ignored or considered relevant in practice. But some of them thought that there should be consistency with IAS 40. If services are considered 'insignificant ancillary services' as defined in paragraph 11 of IAS 40, they should not give rise to a business as defined in IFRS 3.

(d) **Questions 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 is, from a legal perspective, an asset or a share deal?

None of the national standard-setters reported that it makes a difference to the classification of the acquisition as either a business combination or the acquisition of a single asset if the acquisition is, from a legal perspective, an asset or a share deal. Preparers of financial statements 'look through' the legal structure of the entity when classifying the acquisition as a business combination or the acquisition of a single asset. Only the substance of the transaction is relevant.

9. One national standard-setter noted that this issue is also common in other industries such as extractive industries and shipping.

Staff analysis

10. Our analysis addresses the following issues:
    (a) interrelation of IFRS 3 and IAS 40;
    (b) ancillary services;
    (c) insignificant service; and
    (d) possible guidance.

Interrelation of IFRS 3 and IAS 40

11. Neither IFRS 3 nor IAS 40 contains a limitation in its scope that restricts its application when the other standard applies, i.e. there is nothing in the scope of each standard to suggest that they are mutually exclusive.

12. Consequently, we think that both standards apply if an investment property is acquired as part of a business as defined in IFRS 3. Preparers of IFRS financial statements have to assess whether the acquisition meets the definition of a business combination as set out in Appendix A and paragraphs B5 – B12 of IFRS 3, as well as whether the acquired asset meets the definition of an investment property as set out in paragraph 5 of IAS 40.

13. This conclusion is supported by paragraphs 76(b) and 79(d)(ii) of IAS 40 that require a reconciliation of the carrying amount of investment property at the beginning and end of the period to show additions resulting from acquisitions through business combinations separately from other additions that include other acquisitions.

14. Applying both standards means that the investment property is recognised on the acquisition date at fair value (see paragraph 18 of IFRS 3) instead of at cost (see paragraph 20 of IAS 40), with the transaction cost being expensed (see paragraph 53 of IFRS 3) and not being included in cost (see paragraph 20 of IAS 40).

15. In addition, when the investment property is acquired as part of the business combination, the initial recognition exceptions for deferred tax assets and liabilities in paragraphs 15 and 24 of IAS 12 *Income Taxes* do not apply to deferred tax assets and liabilities related to that investment property (see paragraphs 15(b)(i) and 24(a) of IAS 12).

16. Apart from the initial measurement of the investment property, all the provisions of IAS 40 apply to an investment property acquired as part of a business combination, especially the provisions in IAS 40 on the subsequent accounting (see paragraph 15 of IFRS 3).

17. Therefore, we think that an entity acquiring a rented property has to determine whether it meets the definition of both a business as defined in Appendix A of IFRS 3 and an investment property as defined in paragraph 5 of IAS 40.

Ancillary services

18. Paragraph 11 of IAS 40 describes security and maintenance services provided by the owner of an office building to the lessees who occupy the building as typical examples of ancillary services that are so insignificant that they are ignored in determining whether the property is classified as an investment property.

19. We have been informed by some national standard-setter that based on this guidance several practitioners think that the property together with associated insignificant ancillary services is one single 'unit of account' and that this unit of

account is considered one asset, called investment property. Consequently, the acquirer of a property with multiple tenants who adopts associated processes such as security and maintenance acquires one asset instead of inputs and processes applied to those inputs that have the ability to create outputs, ie a business (see paragraph B7 of IFRS 3).

20. However, we do not think that the purpose of the guidance in paragraphs 11-14 of IAS 40 is to delineate a business combination from the acquisition of a single asset, or the scope of IFRS 3 from the scope of initial recognition requirements in paragraph 20-29 of IAS 40. Instead, we think that these paragraphs have been developed to differentiate investment property from owner-occupied property (see paragraph 12 of IAS 40), or to delineate the scope of IAS 40 from the scope of IAS 16 *Property, Plant and Equipment* (see paragraph 7 of IAS 40).

21. Furthermore, we do not have evidence that Board explicitly discussed the interrelation of IFRS 3 and IAS 40 or the significance of ancillary services provided by the owner of a building to the lessees who occupy the building for the classification of an acquisition of an investment property with associated processes as a business during the business combinations project.

22. Some proponents of the view that the 'unit of account' is the property together with associated insignificant ancillary services think that there would be no purpose for the guidance on the initial recognition of an investment property in paragraphs 20-29 of IAS 40, if the acquisition of a single investment property with insignificant ancillary services would be considered a business combination. In this case, they think that acquisition of an investment property would always be accounted for as a business combination, in which case the guidance in IAS 40 on initial recognition would be redundant.

23. However we are not persuaded by this argument because IAS 40 also applies to (see paragraph 8(a) and (b) of IAS 40):

    (a) land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business; and

    (b) land held for a currently undetermined future use, which may be unimproved land where no activity takes place on it.

Insignificant service

24. As explained in agenda paper 8 presented in the July 2011 Committee meeting[1], we think that processes should be more than insignificant in order to lead to the conclusion that it is a business as defined in IFRS 3.

25. 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 that 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 it being defined as a business.

26. Consequently, it may be argued that the guidance in paragraph 11-14 of IAS 40 could be helpful in determining whether processes associated to investment property are insignificant or not.

27. However, we conclude from the explanations in paragraph BC18 of IFRS 3 that the Board wanted a broad definition of a business. For example, it clarified in paragraph B8 of IFRS 3 that a business need not include all of the inputs or processes that the seller used in operating a business if a market participant is capable of continuing to produce outputs, for example, by integrating the business with its own inputs and processes. The Board thought that this clarification also helps avoid the need for extensive detailed guidance and assessments about whether a missing input or process is minor (see paragraph BC18(d) of IFRS 3). In addition, the only reason why the Board did not expand the scope of IFRS 3 to all acquisitions of groups of assets was that it thought that to do so would require further research and deliberation of additional issues and delay the implementation of the revised standards' improvement to practice (see paragraph BC20 of IFRS 3).

28. Considering that the Board wanted a broad definition of business, we don't think that the guidance in paragraph 11-14 of IAS 40 is appropriate to be used in

[1] http://www.ifrs.org/NR/rdonlyres/88D5094A-DF8F-4C52-B5D1-BA7C2BC6F422/0/081107ob08IFRS3Definitionofabusiness.pdf

delineating business combinations from acquisitions of a single asset/investment property. The security and maintenance services provided by an owner of an office building to the lessees who occupy that building is, according to paragraph 11 of IAS 40, a typical example of insignificant ancillary services. In terms of a broad definition of a business though, we think security and maintenance services can give rise to a business as defined in IFRS 3, at least in the case of larger office buildings. We think the dividing line between a business combination and the acquisition of a single investment property could be assessed relative to the amount of property administration services that an average person could render in-house in his/her spare time alongside his/her ordinary employment. Services that go beyond this line typically require the involvement of professional service provider or an organised workforce, which we think indicates that the processes have at least some importance to the asset and so define it as a business.

29. For the same reason, we think that a contract to provide ongoing services related to an asset creates a rebuttable presumption that there are processes that give rise, together with the asset, to a business (see paragraph 18 of agenda paper 8 for the July 2011 Committee meeting[1]).

Possible guidance

30. We think that it is possible to develop application guidance on how to determine if and when an obligation incurred to provide services in association with the acquisition of an asset would lead to a business.

31. We acknowledge that distinguishing a business combination from the acquisition of a single significant asset may require significant judgement. However, we think that the conclusions presented in paragraph 29 of agenda paper 8 for the July 2011 Committee meeting[1] could, together with corresponding explanations in the basis for conclusions on IFRS 3, contribute to a consistent application of the definition of a business as defined in IFRS 3:

(a) A contract requiring the provision of 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 an 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).

32. Furthermore, investment property-specific guidance could be given by delineating the scope of IFRS 3 and IAS 40. Application guidance may be added to IAS 40 that illustrates when the initial recognition provisions in paragraph 20-29 of IAS 40 apply and when IFRS 3 supersedes those provisions. The level of significance of administration services required could be indicated by giving an example of a multi-storey dwelling and describing the number of apartments in that house and the services rendered. A multi-storey dwelling with 15 apartments, for example, would be considered a business.

33. Considering the feedback from one national standard setter that the issue is also common in other industries (see paragraph 9 above) we will undertake further outreach to interested parties from other industry sectors such as extractive industries and shipping to verify whether further, general, application guidance on the business definition should be developed.

Staff recommendation

34. We note that there is no clear guidance on whether an asset with relatively simple associated processes meets the definition of a business in accordance with IFRS 3. This lack of guidance has resulted in significant diversity in practice when 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, is acquired.

35. To ensure consistent application, we recommend amending the application guidance in Appendix B of IFRS 3 and to add application guidance to IAS 40 as indicated in paragraphs 31-32 above.

36. In addition, we recommend performing outreach to interested parties from industry sectors other than the real estate sector to find out whether application guidance or interpretations should be developed for other kinds of assets and what this guidance should look like.

37. Although the Boards wanted a common definition of a business (see paragraph BC18 of IFRS 3), such a clarification might result in a difference between IFRSs and US GAAP. To avoid this difference we are in an on-going dialogue with the FASB staff on this issue with the aim of developing a common proposal.

38. If the Committee agrees with our recommendations, we would present a discussion of the results from outreach to FASB and other industries together with draft application guidance at the November 2011 Committee meeting.

39. We have received a comment letter from constituent[2] that is attached to this agenda paper. The constituent strongly supports the Committee taking this issue onto its agenda and recommends that the Committee considers three additional questions in any future deliberations:

    (a) If the acquired integrated set of activities and assets includes only observable inputs and outputs, are processes presumed to be embedded in the acquisition such that the acquired set would constitute a business?

    (b) When assessing whether a market participant is capable of acquiring a business and continuing to produce outputs, how (from what perspective) is ‘output’ determined?

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[2] E&Y

(c) Do studies/research/know-how represent an input, a process or an output?

40. If the Committee agrees with our recommendation to address this issue through annual improvements, we will consider these questions in developing our paper for the November 2011 Committee meeting.

Annual improvements criteria assessment

41. In planning whether an issue should be addressed by amending IFRSs within the annual improvements project, the IASB assesses the issue against certain criteria. All the criteria (a)-(d) must be met to qualify for inclusion in annual improvements. We have assessed the proposed amendment against the enhanced annual improvements criteria, which are reproduced in full below:

Annual improvements criteria	Staff assessment of the proposed amendment
(a) The proposed amendment has one or both of the following characteristics: (i) clarifying—the proposed amendment would improve IFRSs by: • clarifying unclear wording in existing IFRSs, or • providing guidance where an absence of guidance is causing concern. A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle. (ii) correcting—the proposed amendment would improve IFRSs by: • resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirements should be applied, or • addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs. A correcting amendment does not propose a new principle or a change to an existing principle, but may create an exception from an	(a) Yes. The proposed amendment clarifies the accounting for the acquisition of assets with relatively simple associated processes, in particular the accounting for the acquisition of investment property. The clarifying amendment maintains consistency with the existing principles in IFRS 3 and IAS 40 for the accounting for business combinations and investment property.

existing principle.	
(b) The proposed amendment is well-defined and sufficiently narrow in scope such that the consequences of the proposed change have been considered.	(b) Yes. We believe that the proposed amendment is well defined and is sufficiently narrow in scope such that the consequences of the proposed change have been considered—it ensures consistent accounting for the acquisition of assets with relatively simple associated processes, especially the accounting for the acquisition of investment property.
(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach conclusion on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.	(c) Yes. We think that the IASB will reach a conclusion on this issue on a timely basis, because it aligns with its previous decisions.
(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a need to make the amendment sooner than the project would.	(d) Yes. We expect the post-implementation review on business combinations to start in Q2 of 2012 and to last about 12 months before standard setting action will be considered. It is not foreseeable that this standard setting action will include application guidance on the business (combination) definition.

42. Following the analysis in the table above, in our opinion, the proposed amendment satisfies the annual improvements criteria.

Questions for the Committee
1. Does the Committee agree with the staff's analysis in paragraphs 10-33? 2. Does the Committee agree that application guidance would improve consistent application and financial reporting? 3. Does the Committee agree with our recommendations in paragraphs 34-40? 4. Does the Committee agree with our proposal that the Committee should recommend that the Board should address this issue through the annual improvements process?

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.**

Classifying or designating identifiable assets acquired and liabilities assumed in a business combination

15 **At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to apply other IFRSs subsequently. The acquirer shall make those classifications or designations on the basis of the contractual terms, economic conditions, its operating or accounting policies and other pertinent conditions as they exist at the acquisition date.**

Measurement principle

18 **The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.**

Acquisition-related costs

53 Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder’s fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognised in accordance with IAS 32 and IFRS 9.

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.

Appendix A – **business combination** A transaction or other event in which an **acquirer** obtains control of one or more **businesses**. Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also **business combinations** as that term is used in this IFRS.

Identifying a business combination (application of paragraph 3)

B5 This IFRS defines a business combination as a transaction or other event in which an acquirer obtains control of one or more businesses. An acquirer might obtain control of an acquiree in a variety of ways, for example:

(a) by transferring cash, cash equivalents or other assets (including net assets that constitute a business);

(b) by incurring liabilities;

(c) by issuing equity interests;

(d) by providing more than one type of consideration; or

(e) without transferring consideration, including by contract alone (see paragraph 43).

B6 A business combination may be structured in a variety of ways for legal, taxation or other reasons, which include but are not limited to:

(a) one or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer;

(b) one combining entity transfers its net assets, or its owners transfer their equity interests, to another combining entity or its owners;

(c) all of the combining entities transfer their net assets, or the owners of those entities transfer their equity interests, to a newly formed entity (sometimes referred to as a roll-up or put-together transaction); or

(d) a group of former owners of one of the combining entities obtains control of the combined entity.

Definition of a business (application of paragraph 3)

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:

(a) to continue to exclude self-sustaining as the definition in IFRS 3 did, and instead, provide that the integrated set of activities and assets must be **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. Focusing on the capability to achieve the purposes of the business helps avoid the unduly restrictive interpretations that existed in accordance with the former guidance.

(b) to clarify the meanings of the terms *inputs, processes* and *outputs* that were used in both EITF Issue 98-3 and IFRS 3. Clarifying the meanings of those terms, together with other modifications, helps eliminate the need for extensive detailed guidance and the misinterpretations that sometimes stem from such guidance.

(c) to clarify that inputs and processes applied to those inputs are essential and that although the resulting outputs are normally present, they need not be present. Therefore, an integrated set of assets and activities could qualify as a business if the integrated set is capable of being conducted and managed to produce the resulting outputs. Together with item (a), clarifying that outputs need not be present for an integrated set to be a business helps avoid the unduly restrictive interpretations of the guidance in EITF Issue 98-3.

(d) to clarify that a business need not include all of the inputs or processes that the seller used in operating that business if a market participant is capable of continuing to produce outputs, for example, by integrating the business with its own inputs and processes. This clarification also helps avoid the need for extensive detailed guidance and assessments about whether a missing input or process is minor.

(e) to continue to exclude a presumption that an integrated set in the development stage is not a business merely because it has not yet begun its planned principal operations, as IFRS 3 did. Eliminating that presumption is consistent with focusing on assessing the capability to achieve the purposes of the business (item (a)) and helps avoid the unduly restrictive interpretations that existed with the former guidance.

BC20 The boards considered whether to expand the scope of the revised standards to all acquisitions of groups of assets. They noted that doing so would avoid the need to distinguish between those groups that are businesses and those that are not. However, both boards noted that broadening the scope of the

revised standards beyond acquisitions of businesses would require further research and deliberation of additional issues and delay the implementation of the revised standards' improvements to practice. The boards therefore did not extend the scope of the revised standards to acquisitions of all asset groups. Paragraph 2(b) of the revised IFRS 3 describes the typical accounting for an asset acquisition.

Extracts from IAS 12 *Income Taxes*

Taxable temporary differences

15 **A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:**

(a) the initial recognition of goodwill; or

(b) the initial recognition of an asset or liability in a transaction which:

(i) is not a business combination; and

(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax liability shall be recognised in accordance with paragraph 39.

Deductible temporary differences

24 **A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:**

(a) is not a business combination; and

(b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax asset shall be recognised in accordance with paragraph 44.

Extracts from IAS 40 *Investment Property*

Definitions

5 **The following terms are used in this Standard with the meanings specified:**

... *Investment property* is property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business. …

7 Investment property is held to earn rentals or for capital appreciation or both. Therefore, an investment property generates cash flows largely independently of the other assets held by an entity. This distinguishes investment property from owner-occupied property. The production or supply of goods or services (or the use of property for administrative purposes) generates cash flows that are attributable not only to property, but also to other assets used in the production or supply process. IAS 16 *Property, Plant and Equipment* applies to owner-occupied property.

8 The following are examples of investment property:

(a) land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.

(b) land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.)

(c) a building owned by the entity (or held by the entity under a finance lease) and leased out under one or more operating leases.

(d) a building that is vacant but is held to be leased out under one or more operating leases.

(e) property that is being constructed or developed for future use as investment property.

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.

14 Judgement is needed to determine whether a property qualifies as investment property. An entity develops criteria so that it can exercise that judgement consistently in accordance with the definition of investment property and with the related guidance in paragraphs 7–13. Paragraph 75(c) requires an entity to disclose these criteria when classification is difficult.

Measurement at recognition

20 An investment property shall be measured initially at its cost. Transaction costs shall be included in the initial measurement.

21 The cost of a purchased investment property comprises its purchase price and any directly attributable expenditure. Directly attributable expenditure includes, for example, professional fees for legal services, property transfer taxes and other transaction costs.

22 [Deleted]

23 The cost of an investment property is not increased by:

(a) start-up costs (unless they are necessary to bring the property to the condition necessary for it to be capable of operating in the manner intended by management),

(b) operating losses incurred before the investment property achieves the planned level of occupancy, or

(c) abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property.

24 If payment for an investment property is deferred, its cost is the cash price equivalent. The difference between this amount and the total payments is recognised as interest expense over the period of credit.

25 The initial cost of a property interest held under a lease and classified as an investment property shall be as prescribed for a finance lease by paragraph 20 of IAS 17, ie the asset shall be recognised at the lower of the fair value of the property and the present value of the minimum lease payments. An equivalent amount shall be recognised as a liability in accordance with that same paragraph.

26 Any premium paid for a lease is treated as part of the minimum lease payments for this purpose, and is therefore included in the cost of the asset, but is excluded from the liability. If a property interest held under a lease is classified as investment property, the item accounted for at fair value is that interest and not the underlying property. Guidance on determining the fair value of a property interest is set out for the fair value model in paragraphs 33–52. That guidance is also relevant to the determination of fair value when that value is used as cost for initial recognition purposes.

27 One or more investment properties may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers to an exchange of one non-monetary asset for another, but it also applies to all exchanges described in the preceding sentence. The cost of such an investment property is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired asset is measured in this way even if an entity cannot immediately derecognise the asset given up. If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

28 An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred, or

(b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange, and

(c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For the purpose of determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction shall reflect post-tax cash flows. The result of these analyses may be clear without an entity having to perform detailed calculations.

29 The fair value of an asset for which comparable market transactions do not exist is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that asset or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value. If the entity is able to determine reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

Fair value model

76 In addition to the disclosures required by paragraph 75, an entity that applies the fair value model in paragraphs 33–55 shall disclose a reconciliation between the carrying amounts of investment property at the beginning and end of the period, showing the following:

(a) additions, disclosing separately those additions resulting from acquisitions and those resulting from subsequent expenditure recognised in the carrying amount of an asset;

(b) additions resulting from acquisitions through business combinations;

(c) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 and other disposals;

(d) net gains or losses from fair value adjustments;

(e) the net exchange differences arising on the translation of the financial statements into a different presentation currency, and on translation of a foreign operation into the presentation currency of the reporting entity;

(f) transfers to and from inventories and owner-occupied property; and

(g) other changes.

Cost model

79 In addition to the disclosures required by paragraph 75, an entity that applies the cost model in paragraph 56 shall disclose:

(a) the depreciation methods used;

(b) the useful lives or the depreciation rates used;

(c) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period;

(d) a reconciliation of the carrying amount of investment property at the beginning and end of the period, showing the following:

(i) additions, disclosing separately those additions resulting from acquisitions and those resulting from subsequent expenditure recognised as an asset;

(ii) additions resulting from acquisitions through business combinations;

(iii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 and other disposals;

(iv) depreciation;

(v) the amount of impairment losses recognised, and the amount of impairment losses reversed, during the period in accordance with IAS 36;

(vi) the net exchange differences arising on the translation of the financial statements into a different presentation currency, and on translation of a foreign operation into the presentation currency of the reporting entity;

(vii) transfers to and from inventories and owner-occupied property; and

(viii) other changes; and

(e) the fair value of investment property. In the exceptional cases described in paragraph 53, when an entity cannot determine the fair value of the investment property reliably, it shall disclose:

(i) a description of the investment property;

(ii) an explanation of why fair value cannot be determined reliably; and

(iii) if possible, the range of estimates within which fair value is highly likely to lie.

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International Financial Reporting Standards Interpretations Committee
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19 August 2011

Dear IFRS Interpretations Committee members,

Tentative Agenda Decision – IFRS 3 *Business Combinations* – definition of a 'business'

The global organisation of Ernst & Young is pleased to submit its comments on the discussion by the IFRS Interpretations Committee (the Interpretations Committee) on the definition of a business that occurred during the July 2011 meeting. We believe that the definition of a business determination is a significant practice issue and are aware of emerging differences of interpretation of what constitutes a business under IFRS across a wide array of industries. In addition to the issues raised at the last Interpretations Committee meeting, we have included below a series of questions that highlights other specific practice areas where differences of interpretation have emerged.

We strongly support the Interpretations Committee taking this issue onto its agenda and recommend that the Interpretations Committee consider these additional questions in any future deliberations. We believe that many of these issues could be addressed by adding examples to IFRS 3, or further clarifying Appendix B to IFRS 3. Further, given that IFRS 3 and ASC 805 *Business Combinations* are converged standards, we recommend that the IASB work with the FASB staff (or EITF) to reach a converged solution.

1. **If the acquired integrated set of activities and assets includes only observable inputs and outputs, are processes presumed to be embedded in the acquisition such that the acquired set would constitute a business?**

   When an acquired integrated set of activities and assets includes inputs and outputs but no observable process, we are aware of potential diversity in practice in the determination of whether the acquired set of activities and assets constitutes a business. Some believe that because the revenue producing activities associated with the acquired set remain substantially the same before and after the acquisition, processes are embedded in the acquisition and, therefore, the acquired set constitutes a business. However, others believe that regardless of the fact there is a continuing revenue stream, if the acquired set does not include an observable process, the acquired set does not constitute a business.

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The following example in the real estate industry illustrates these two views[1].

Example 1: Acquisition of land and fully leased large commercial building subject to a long term lease

Entity A acquires (1) land and (2) a fully-leased large commercial building with long-term leases with multiple tenants. Entity A does not acquire the processes that have been established to manage the leases (e.g., lease management, selection of tenants, marketing decisions, investment decisions) or the processes to provide services (e.g., security, cleaning, maintenance) to the building. Entity A will provide lease management and other building services through its own employees or through new outsourcing contracts with suppliers.

View A: Entity A acquired a business pursuant to IFRS 3. Entity A acquired inputs (the land and fully leased building) and outputs (rental income). Because the revenue producing activities associated with the acquired set of activities and assets remain substantially the same before and after the acquisition, processes are embedded in the acquisition and, therefore, the acquired set constitutes a business.

View B: Entity A did not acquire a business pursuant to IFRS 3. While Entity A acquired inputs (land and fully leased building) and outputs (rental income), because it did not acquire any observable process, the acquired set of activities and assets is not a business even though the building is currently generating rental income. While IFRS 3 states that not *all* of the processes used in operating the business need to be acquired, proponents of this view believe that an observable process must be included in the acquired set for the acquisition to meet the definition of a business.

2. **When assessing whether a market participant is capable of acquiring a business and continuing to produce outputs, how (from what perspective) is "output" determined?**

   When assessing whether a market participant is capable of acquiring a business and continuing to produce outputs, we are aware of potential diversity in practice (particularly in the extractive industry) on how (from what perspective) "output" is considered. Some consider "output" from the perspective of a market participant whereas others consider "output" from the perspective of the acquirer.

   Those that believe "output" should be considered from the perspective of a market participant point to the guidance in paragraph B11 of Appendix B to IFRS 3. This paragraph states "Thus, in evaluating whether a particular set [of activities and assets] is

[1] This issue is also prevalent in other industries. For example, in the shipping industry, a buyer may acquire only a ship and the charter (but not a crew or any other processes). In the banking industry, a buyer may acquire only a portfolio of financial assets (but not employees to manage or collect cash flows from the portfolio, or any other processes).

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." This paragraph clarifies that the perspective of the acquirer is irrelevant in the definition of a business determination and that "output" should be considered from the perspective of a market participant.

Those that believe "output" should be considered from the perspective of the acquirer point to the reference to "continuing to produce outputs" in paragraph B8 of Appendix B to IFRS 3. That is, in evaluating whether a market participant is capable of continuing to produce outputs, only outputs that the acquirer intends to create are considered (i.e., only market participants in the same market as the acquirer are considered). In this case, if the seller were producing an output different from the one intended by the acquirer or the acquired set of activities and assets is not capable of currently producing the output intended by the acquirer, then the acquired set would not constitute a business.

The following example in the extractive industry illustrates these two views.

Example 2: Acquisition of a mineral interest in which the seller has performed geological studies and surveys and has commenced exploration activities

ABC Co. and Target Co. are mining companies. ABC Co. is a large exploration and production entity and Target Co. is a junior exploration stage entity. Target Co. owns land and a mineral interest and its principal activity is the exploration of this property (not necessarily the extraction of the mineral resources). Target Co. has some exploration processes (it has conducted drilling, sampling, geological studies, etc.) and determined through the resulting data that there are inferred, measured and/or indicated mineral resources, but has not yet commenced extraction of the minerals. ABC Co.'s intended output is the mineral itself. ABC Co. acquires Target Co. and thus acquires the interest in the mineral property and the exploration processes and resulting data.

View A: ABC Co. acquired a business under IFRS 3. ABC Co. acquired inputs (land and mineral interest) and processes (exploration processes). Because the acquired set of activities and assets is capable of providing a return to investors and a market participant would be capable of continuing the exploration activities to create outputs, ABC Co. acquired a business. The acquired set of integrated activities and assets is considered a business even though Target Co. is not currently producing the mineral (the intended output of ABC Co.).

View B: ABC Co. did not acquire a business under IFRS 3. ABC Co. acquired inputs (land and mineral interest) and processes (exploration processes). Because the property is not currently producing the output intended by ABC Co., the acquired set is not a business.

3. **Do studies/research/know-how represent an input, a process or an output?**

When an acquired set of integrated activities and assets includes studies/research/know-how, we are aware of potential diversity in practice (particularly in the life sciences and extractive industries[2]) on whether such information represents an input, a process or an output. Often, this issue arises when an integrated set of activities and assets is in the development stage.

The following example in the life sciences industry illustrates the different views.

Example 3: License to a product candidate

Pharma A licenses a product candidate from Biotech B. The terms of the license agreement entitle Pharma A to the "know how" associated with the product candidate. The license agreement defines the "know how" as "all biological materials and other tangible materials, inventions, practices, methods, protocols, formulas, knowledge, know-how, trade secrets, processes, procedures, specifications, assays, skills, experience, techniques, data and results of experimentation and testing, including pharmacological, toxicological, safety, stability and pre-clinical and clinical test data and analytical and quality control data, patentable or otherwise." Pharma A does not acquire any employees or other processes from Biotech B.

View A: Pharma A did not acquire a business under IFRS 3. Pharma A has acquired only inputs (license and "know how"). The "know how" represents an input that enhances the value of the product candidate. "Know how" is not viewed as a system, standard, protocol, convention or rule that when applied to the license, creates or has the ability to create outputs, and therefore is not a process. While Pharma A acquired inputs (license and "know how"), it did not acquire any processes to apply to the license to create outputs.

View B: Pharma A acquired a business under IFRS 3. Pharma A has acquired inputs (license) and processes ("know how"). The "know how" represents a process that can be applied to the license to create outputs. That is, a market participant would be capable of using the "know how" to continue the development of the product candidate to create outputs (e.g., the commercialisation of the product candidate or achieving certain stages of furthered development of clinical trials, which may increase the value of the product candidate).

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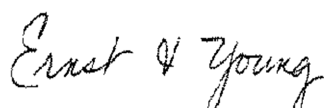
[2] In addition, we believe that this issue may have relevance to other industries where intellectual property is commonly acquired, such as in the technology industry.

View C: Pharma A acquired a business under IFRS 3. Pharma A has acquired inputs (license) and outputs ("know how"). The "know how" represents an output because a market participant could license/sell the product candidate and "know how" to generate a return. In some cases, market participants are not in the business of developing and commercialising a product candidate[3]. Instead, after the product candidate achieves a certain stage of clinical development, such market participants will license/sell the product candidate and "know how" to another party for final development and commercialisation. Because the acquired set of activities and assets is capable of providing a return to investors, processes are embedded[4] in the acquisition and, therefore, the acquired set constitutes a business.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas at the above address or on +44 (0)20 7951 3152.

Yours faithfully



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Emerging Issues Task Force

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[3] This can also be seen in Example 2.
[4] See Issue 1.