STAFF PAPER

27 February—2 March 2012

IASB Meeting

Previous meetings:
IFRS IC: Sep 2011 + Nov 2011

Project	**Annual Improvements (2011-2013 cycle)**		
Paper topic	IFRS 3 *Business Combinations*—Definition of a business		
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Introduction

1. At the September 2011 meeting[1], the IFRS Interpretations Committee (the Committee) discussed the interrelationship of IFRS 3 *Business Combinations* and IAS 40 *Investment Property*, ie whether the acquisition of investment property can be a business combination.

2. At the November 2011 meeting[2], the Committee recommended that the Board should include a proposed amendment to IAS 40 within the next exposure draft of *Improvements to IFRSs.*

3. The purpose of this paper is to ask the Board whether it agrees with the proposed annual improvement to IAS 40, which would clarify the interrelationship between IIFRS 3 and IAS 40, thereby contributing to a more consistent application of both standards if investment property is acquired.

4. The paper will therefore:

   (a) provide a brief explanation of the issue;

   (b) provide an assessment of the proposed amendments against the criteria for inclusion in Annual Improvements;

[1] Refer to Agenda paper 4—http://www.ifrs.org/NR/rdonlyres/B2EB0FC1-3F23-447F-BD8D-8DDA2CA95F7E/0/041109AP04AIPIFRS3Definitionofabusiness.pdf

[2] Refer to Agenda paper 6— http://www.ifrs.org/NR/rdonlyres/DB1E2C48-213D-4CFB-AB61-705248E7BBD0/0/061111AP06AIP20112013IFRS3Definitionofabusiness.pdf

(c) make a recommendation for a proposed amendment to IAS 40; and

(d) ask the Board whether they agree with the recommendation.

Explanation of the issue

5. The Committee received a request seeking clarification on whether an asset with relatively simple associated processes meets the definition of a business in accordance with IFRS 3. More specifically, the question was whether the acquisition 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, constitutes a business as defined in IFRS 3.

6. The Committee noted that the issue goes beyond the scope of its activities because the difficulty in determining whether an acquisition meets the definition of a business in Appendix A of IFRS 3 is not limited to the acquisition of investment property. Consequently, the Committee thinks that the issue should be addressed by the Board as part of its post-implementation review of IFRS 3. The Committee wants to contribute its experience and the results from its discussions on the issue to that review. A paper summarising the information gathered as a result of this request will be prepared and provided to the Board's post-implementation review team after it has been discussed by the Committee.

7. However, in the course of its discussions, the Committee noted that there is uncertainty about the interrelationship of IFRS 3 and IAS 40 when investment property with associated insignificant ancillary processes is acquired:

   (a) Some consider both standards to be mutually exclusive if investment property with associated insignificant ancillary services as specified in paragraph 11 of IAS 40 is acquired.

   (b) Others, in contrast, think that an entity acquiring such investment property has to determine whether it meets both definitions.

8. To remove that uncertainty, the Committee directed the staff to analyse whether a clarification can be made through the annual improvements process.

Analysis of the issue

9. After analysing the issue, we presented our view to the Committee that IFRS 3 and IAS 40 are not mutually exclusive. An entity has 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 or assets meet(s) the definition of investment property as set out in paragraph 5 of IAS 40.

10. In summary, we reached this preliminary conclusion for the following reasons:

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

    (b) Paragraphs 76(b) and 79(d)(ii) of IAS 40 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.

    (c) The guidance in paragraphs 10-14 of IAS 40 on ancillary services is intended to delineate investment property from owner-occupied property (or to delineate the scope of IAS 40 to distinguish it from the scope of IAS 16 *Property, Plant and Equipment*), and not to delineate a business combination from the acquisition of a single asset or a group of assets, or not to delineate the scope of IAS 40 to distinguish it from the scope of IFRS 3. (For ease of reference, we have included extracts from the September 2011 Committee meeting agenda paper in Appendix B, which explains the purpose of the guidance in paragraphs 10-14 of IAS 40 on ancillary services in greater detail.)

11. The Committee agreed with our analysis and noted that there is a significant lack of clarity about the interrelationship of IFRS 3 and IAS 40 when investment property with associated insignificant ancillary processes is acquired.

Amending IAS 40

12. We think that the most appropriate approach to clarify the interrelationship between IFRS 3 and IAS 40, if investment property with insignificant ancillary services, as specified in paragraph 11 of IAS 40, is acquired, is to highlight that the accounting for such transactions requires entities to exercise judgement twice:
    (a) to determine whether property qualifies as investment property or owner-occupied property; and
    (b) to determine whether the acquisition of investment property is the acquisition of a single asset or a group of assets or a business combination within the scope of IFRS 3.
13. The judgement that is needed to determine whether property qualifies as investment property or owner-occupied property is explicitly stated in paragraph 14 of IAS 40 and the guidance supporting that judgement is found in paragraphs 7-15 of IAS 40.
14. We propose, therefore, that the judgement needed to determine whether the acquisition of investment property is the acquisition of a single asset or a group of assets or a business combination in the scope of IFRS 3 should be explicitly distinguished by adding a paragraph 14A after paragraph 14 of IAS 40. This paragraph should clarify that:
    (a) it is a second instance where judgement is needed;
    (b) both judgements are determinations that are independent of each other; and
    (c) the guidance supporting the judgement to determine whether the acquisition of investment property is a business combination is not included in IAS 40 but is instead in IFRS 3.
15. In addition, we think that divergent views on the interrelationship between IFRS 3 and IAS 40, if investment property with insignificant ancillary services as specified in paragraph 11 of IAS 40 is acquired, partly result from the fact that IAS 40 does not make a clear statement as to which issue is addressed by paragraphs 6-15 of IAS 40. Consequently, we propose to add a heading before

paragraph 6 of IAS 40 that makes reference to the classification of property either as investment property or as owner-occupied property.

16. We think that such an amendment would clarify that IFRS 3 and IAS 40 are not mutually exclusive if investment property with insignificant ancillary services as specified in paragraph 11 of IAS 40 is acquired.

17. The Committee agreed with our recommendation.

Annual Improvements criteria assessment

18. We assessed the potential amendment to IAS 40, whose aim is to clarify the scope of IFRS 3 if investment property is acquired, against the annual improvements criteria. The assessment is reproduced in full in Appendix C to this paper.

19. On the basis of the assessment, we recommended to the Committee that the proposed amendment should be made through Annual Improvements. The Committee agreed with this recommendation.

Transition

20. The accounting for some past transactions might be questioned if the proposed amendment is applied retrospectively. The question of prospective or retrospective application therefore needs to be considered.

21. If a new standard, or an amendment to a standard, changes the accounting policy of the entity upon initial application, it shall apply the change retrospectively, but only if the new standard or the amendment to a standard does not include a specific transitional provision (see paragraph 19(b) of IAS 8).

22. As noted above, applying the proposed amendments to IAS 40 as set out in Appendix A to this paper retrospectively may result in an entity applying IFRS 3 to transactions that have been accounted for in previous periods as the acquisition of a single asset or a group of assets recognised at cost at acquisition date. Accordingly, the acquisition-date fair value of several items recognised in accordance with IFRS 3 may not have been determined in previous periods.

23. In this context, we are not such much concerned with the fair value of the investment properties itself at the acquisition date. This is because, at the very least, the fair value of acquired investment property at the next balance sheet date must have been determined, either for applying the fair value model for subsequent measurement of investment property or for the disclosure that is required by paragraph 79(e) of IAS 40.

24. Instead, we have in mind assets and liabilities that are only recognised under IFRS 3, eg contingent liabilities or indemnification assets.

25. The acquisition-date fair value of contingent consideration may be another example of a fair value that may have not been determined in previous periods because of a different accounting policy for contingent consideration for a single asset or a group of assets.

26. To avoid the use of hindsight in determining the acquisition-date fair value of the intangible assets acquired, and of the liabilities assumed as part of the business combination transaction, we think that the proposed amendment to IAS 40 should be applied prospectively.

27. The Committee agreed with our recommendation.

Consequential amendments

28. We reviewed the proposed change in relation to other existing IFRSs. We did not identify consequential amendments to other standards.

29. Specifically, we think that no consequential amendment for first-time adopters is needed because appropriate relief is already given through the exemptions for business combinations in Appendix C of IFRS 1 *First-time Adoption of International Financial Reporting Standards.*

The Committee's recommendation to the Board

30. The Committee recommends that the Board should proceed with the proposed improvement to amend IAS 40. Appendix A to this paper includes the draft wording that was presented to the Committee for the proposed amendment.

Questions for the Board
1. Does the Board agree with the Interpretations Committee's recommendation to amend IAS 40 through Annual Improvements? 2. If the Board agrees with the Interpretations Committee's recommendation, does the Board agree with the proposed wording for the Annual Improvement in Appendix A? 3. If the Board agrees with the Interpretations Committee's recommendation, does the Board agree that the amendment should be applied prospectively and that no consequential amendments to other IFRSs are needed?

Appendix A—Proposed wording for Annual Improvements

The proposed amendment to IAS 40 is presented below.

Amendment to IAS 40 *Investment Property*

Before paragraph 6, a heading is added. Paragraphs 14A, 84A and 85D are added. Paragraphs 6 and 14 have been included for ease of reference but are not proposed for amendment.

Classification of property as investment property or owner-occupied property

6 **A *property interest* that is held by a lessee under an operating lease may be classified and accounted for as investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee uses the fair value model set out in paragraphs 33–55 for the asset recognised. This classification alternative is available on a property-by-property basis. However, once this classification alternative is selected for one such property interest held under an operating lease, all property classified as investment property shall be accounted for using the fair value model. When this classification alternative is selected, any interest so classified is included in the disclosures required by paragraphs 74–78.**

[…]

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.

14A Judgement is also needed to determine whether the acquisition of investment property is the acquisition of an asset or a group of assets or a business combination within the scope of IFRS 3 *Business Combinations*. Reference should be made to IFRS 3 to determine whether it is a business combination. The discussion in paragraphs 7-15 of this standard relates to whether or not property is owner-occupied property or investment property and not to whether or not the acquisition of property is a business combination as defined in IFRS 3. Determining whether a specific transaction meets the definition of both a business combination as defined in IFRS 3 and investment property as defined in this standard requires the separate application of both standards independently of each other.

Transitional provisions

[...]

Business Combinations

84A *Improvements to IFRSs* issued in [date] added a heading before paragraph 6 and paragraph 14A. An entity shall apply this amendment prospectively for acquisitions of investment property from the beginning of the first period for which it adopts this amendment. Consequently, amounts recognised for acquisitions of investment property in prior periods shall not be adjusted.

Effective date

[...]

85D *Improvements to IFRSs* issued in [date] added a heading before paragraph 6 and paragraphs 14A and 84A. An entity shall apply those amendments for annual periods beginning on or after [date]. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.

Basis for Conclusions on proposed amendment to IAS 40 *Investment Property*

This Basis for Conclusions accompanies, but is not part of, the proposed amendment

Classification of property as investment property or owner-occupied property

Business combinations

BC1 The IFRS Interpretations Committee (Committee) reported to the Board that practice differed in delineating the scope of IFRS 3 *Business Combinations* and IAS 40 *Investment Property*:

(a) Some considered both standards as mutually exclusive if investment property with associated insignificant ancillary services as specified in paragraph 11 of IAS 40 is acquired. They view property, together with any associated insignificant ancillary services, as being a single ‘unit of account’ and they consider this unit of account to be one asset, called ‘investment property’.

(b) Others, in contrast, did not view IFRS 3 and IAS 40 as being mutually exclusive if investment property with associated insignificant ancillary services as specified in paragraph 11 of IAS 40 is acquired, and nor did they view the definitions of a business as defined in Appendix A of IFRS 3 and investment property as defined in paragraph 5 of IAS 40 as being interrelated. They think that an entity acquiring investment property has to determine whether it meets both definitions.

BC2 The Board considered the guidance in IFRS 3 and IAS 40 for the acquisition of investment property with associated insignificant ancillary services as specified in paragraph 11 of IAS 40. The Board noted that paragraphs 8-14 of IAS 40 have been developed to differentiate investment property from owner-occupied property, or to delineate the scope of IAS 40 to distinguish it from the scope of IAS 16 *Property, Plant and Equipment*. In addition, neither IFRS 3 nor IAS 40 contains a limitation in its scope that restricts its application when the other standard applies, ie there is nothing within the scope of each standard to suggest that they are mutually exclusive. The Board also noted that the wording of IAS 40 is not sufficiently clear about the interrelationship of the two standards.

BC3 The Board agrees with the proponents of the view presented in paragraph BC1(b) that IFRS 3 and IAS 40 are not mutually exclusive. The Board proposes to amend IAS 40 to state explicitly that judgement is also needed to determine whether the acquisition of investment property is the acquisition of an asset or a group of assets or a business combination in the scope of IFRS 3 and that this judgement is not based on paragraphs 7-15 of IAS 40 but the guidance in IFRS 3. Only the judgement needed to distinguish investment property from owner-occupied property is based on these paragraphs.

BC4 Consequently, the Board proposes to clarify the interrelationship of the two standards by adding a heading before paragraph 6 and paragraph 14A to IAS 40.

Effective date and transition

BC5 The Board proposes to add a heading before paragraph 6 and paragraphs 14A, 84A and 85D of IAS 40 to clarify the interrelationship between IFRS 3 and IAS 40. The Board considered the transitional provisions and effective date of the amendment to IAS 40. The Board noted that applying IFRS 3 to transactions that have previously been accounted for as the acquisition of an asset or a group of assets might involve the use of hindsight in determining the acquisition-date fair values of the identifiable assets acquired and of the liabilities assumed as part of the business combination transaction. Consequently, the Board proposes that an entity would apply the proposed amendments to IAS 40 prospectively for annual periods beginning on or after [the effective date].

Appendix B—Extract from IFRS Interpretations Committee agenda paper 4, September 2011

B1. A copy of the original Agenda Paper 4 which was discussed at the IFRS Interpretations Committee meeting in September 2011, can be accessed from the IASB website—http://www.ifrs.org/NR/rdonlyres/B2EB0FC1-3F23-447F-BD8D-8DDA2CA95F7E/0/041109AP04AIPIFRS3Definitionofabusiness.pdf

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.

Appendix C—Annual Improvements assessment criteria

C1. 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 existing principle.	(a) Yes. The proposed amendment clarifies the interrelationship between IFRS 3 and IAS 40. The clarifying amendment maintains consistency with the existing principles in IFRS 3 and IAS 40 for the accounting for business combinations and investment property.
(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 contributes to consistent 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 the existing principles in IFRS 3 and IAS 40 for the accounting for business combinations and investment property.
(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 cannot be predicted whether this standard-setting action will include a clarification on the interrelationship of IFRS 3 and IAS 40.