STAFF PAPER

November 2015

IFRS Interpretations Committee Meeting

Project	**Definition of a business**		
Paper topic	Update on IASB's proposals		
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Introduction

1. In February 2015, the IASB discussed the issues arising from the Post-implementation Review (PIR) of IFRS 3 *Business Combination* and added the definition of a business project to its research agenda.

2. The US Financial Accounting Standards Board (FASB) has a project to improve the application of the definition of a business. The FASB project aims to cover most of the concerns that we heard through our PIR. One of the objectives of the FASB proposals is to move practice under US GAAP to be more aligned with practice under IFRS. The FASB plans to publish an Exposure Draft soon.

3. At their joint meeting in September 2015, the IASB and the FASB discussed the project summaries presented by the IASB and the FASB staff, including the FASB's tentative decisions on how to clarify the definition of a business and related application guidance.

4. In September 2015, the IASB decided that the IASB staff should bring an analysis of the issues already deliberated upon and agreed by the FASB to a future IASB meeting.

5. In October 2015, the IASB discussed an analysis of the FASB's proposals on how to improve the application of the definition of a business and decided to propose changes to IFRS 3 that are the same as the amendments proposed by FASB.

6. During the October 2015 IASB meeting, some IASB members asked whether the proposed amendments would help solve the practical problems that had been raised to the IFRS Interpretations Committee (IFRS IC) about the definition of a business.

Objective

7. The objective of the discussion at this meeting is to get your views on the proposed amendments to IFRS 3. We are not asking the IFRS IC to provide any formal recommendations on the IASB proposals. However, if IFRS IC members have comments on these proposals, then we will report that comments back to the IASB in the December 2015 meeting.

8. For this reason:

    (a) in paragraphs 10 – 59 we reproduce the analysis of the FASB's proposals that we presented at the October 2015 IASB meeting. The IASB agreed with all these proposals; and

    (b) in paragraphs 62 – 64 we demonstrate that the proposed amendments to IFRS 3 would help solve the issues raised to the IFRS IC about the definition of a business.

9. For ease of reference, we reproduce in Appendix C of this paper the existing guidance of IFRS 3 on the definition of a business and the related Basis for Conclusions.

Analysis of FASB proposals presented at the October 2015 IASB meeting

FASB proposals

10. FASB tentatively decided:

    a) to specify that to be considered a business, an acquired set of activities and assets (a set) must include, at a minimum, an input and a substantive process that together contribute to the ability to create outputs (Proposal 1);

b) to remove the requirement that a set is a business if market participants can replace the missing elements and continue to produce outputs (Proposal 2);

c) to not consider a set a business if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets (Proposal 3);

d) to revise the definition of outputs to focus on goods and services provided to customers (Proposal 4);

e) to add examples to help with the interpretation of what is considered a business (Proposal 5); and

f) that an entity would be required to apply the proposed amendments prospectively (Proposal 6).

Proposal 1: Substantive process

11. The FASB decided that to be considered a business, a transaction must include, at a minimum, an input and a substantive process that together contribute to the ability to create outputs. The FASB noted that the existence of a process (or processes) is what distinguishes a business from an asset. The input and substantive process together are only required to contribute to the ability to create outputs, because not all of the inputs and processes needed to create outputs are required for the set of assets to be a business.

12. The FASB noted that it would be difficult to define a substantive process or determine what processes are substantive, because that determination would vary significantly from industry to industry and from transaction to transaction. Consequently, the FASB decided to provide additional guidance to help determine whether a substantive process exists. The proposed guidance includes two different sets of criteria to consider, which depend on whether the acquired set of assets has outputs. This is because when outputs are missing the other elements of a business (ie inputs and processes) should be more significant.

Sets of assets with no outputs

13. The FASB decided that when a set does not have outputs (for example, an early stage company that has not generated revenues), in order to have a substantive

process, the acquired set should include an organised workforce that has the necessary skills, knowledge, or experience to perform an acquired process that, when applied to another acquired input, is critical to the ability to develop or convert that acquired input into outputs. Consequently, both an organised workforce and the input that the workforce can convert into output should be included in the assets acquired.

14. The FASB also decided that an entity should consider the following when evaluating whether the acquired workforce is performing a substantive process:

(a) a process is not critical if, for example, it is considered ancillary or minor in the context of all the processes required to create outputs;

(b) inputs that the organised workforce could develop (or is developing) or convert into outputs could include intellectual property that could be developed into a good or service, resources that could be developed to create outputs, or access to necessary materials or rights that enable the creation of future outputs. Consequently, the acquired set of assets should have an input or inputs that the organised work force could develop into future outputs.

Sets of assets with outputs

15. The FASB decided that when the acquired set of assets has outputs (for example, there is a continuation of revenues before and after the transaction), any of the following would indicate that the set includes a substantive process:

a) the set includes an organised workforce that has the necessary skills, knowledge, or experience to perform an acquired process that, when applied to an acquired input, is critical to the ability to continue producing outputs;

b) the acquired process, when applied to an acquired input, contributes to the ability to continue producing outputs and is considered unique, scarce, or cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

Goodwill

16. Paragraph B12 of IFRS 3 states that:

> 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.

17. The FASB believes that the presumption in paragraph B12 of IFRS 3 that a set with goodwill is a business could conflict with the additional guidance on substantive process proposed by the FASB. For example, if a set includes any employees, even if those employees are not performing a critical process, someone could argue that the presence of those employees indicates that there is at least some goodwill, even if it is a negligible amount. The FASB did not want an entity to be required to conclude that a set is a business in that circumstance. Consequently, the FASB is proposing to amend its equivalent guidance to paragraph B12 of IFRS 3 to clarify that the presence of more than an insignificant amount of goodwill may be an indicator that the acquired process is substantive and that the acquired set of assets is a business.

Staff views on Proposal 1

18. We think that the proposed additional guidance on 'substantive process' would help entities in the assessment of the relevance of processes acquired[1]. Many participants to the PIR of IFRS 3 think that this assessment is challenging, especially when only some of the processes are acquired and it is necessary to determine whether the processes that are acquired (and those missing) are necessary to the production of outputs or are merely administrative processes. We learnt from the PIR of IFRS 3 that the identification of processes that give rise to a business is one of the main challenges in some industries, such as real estate, shipping and banking sector.

[1] Inputs, processes and outputs are defined in paragraph B7 of IFRS 3, please see Appendix B of this paper for further details.

19. In our view, the proposed additional guidance on substantive process would confirm the predominant practice under IFRS, which is: only significant/sophisticated processes give rise to a business. Consequently, the proposed guidance would be a clarification for many IFRS preparers.

20. We think that the proposed guidance for transactions involving sets of assets with no outputs would be helpful, because many participants to the PIR of IFRS 3 think that the current guidance on the definition of a business is not sufficiently clear when the acquired entity does not generate revenues. We learnt from the PIR of IFRS 3 that this issue is particularly relevant in some industries, such as extractive, pharmaceutical and technology.

21. The FASB is proposing more stringent criteria for transactions involving sets of assets with no outputs. We agree with this approach, because we think that when the set of assets acquired does not generate revenues, it should include the inputs that are intended to be converted into output.

22. In contrast, we think that when the acquired set of assets generates revenues before and after the transactions, it is more likely that the set is a business. Inputs are already being converted into output, and, therefore, we agree that it is not necessary to consider the type of inputs acquired. We also agree that an organised workforce might not be required, if for example, the acquired set of assets includes automated processes that contribute to the ability to continue producing outputs.

23. We note that many participants to the PIR of IFRS 3 think that the transfer of a significant number of employees often indicates that the transaction is a business combination. We learnt that they use this indicator in practice. Consequently, we expect that many IFRS preparers would agree with Proposal 1, because under this proposal an organised workforce is an indicator of a substantive process.

24. We think that the presence of goodwill is a strong indicator that the acquired set of assets is a business. However, we agree that the presence of a negligible amount of goodwill does not necessarily mean that the acquired assets should automatically be considered a business.

25. On the basis of the analysis above, we support Proposal 1.

Proposal 2: Market participants capable of replacing missing elements

26. Paragraph B8 of IFRS 3 states that:

> 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.

27. The FASB is proposing to delete the following phrase:

> ~~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~~.

28. The FASB decided to delete this phrase, because Proposal 1 would establish minimum requirements for a set of assets to be a business (ie the set of assets to be a business must have at least an input and a substantive process that together contribute to the ability to create outputs) and therefore, the need for the assessment of a market participant's ability to replace any missing elements and continue producing outputs would diminish.

Staff views on Proposal 2

29. We think that Proposal 2 would help preparers, because many participants to the PIR of IFRS 3 think that some sets of assets may be considered as a business for some market participants if they could integrate the set of assets in their processes. However, the same set of assets may not be considered as a business from the perspective of other market participants. Consequently, they think that the assessment of a market participant's ability to integrate the acquired set of assets can be challenging.

30. In our view, removing the requirement that a set is a business if market participants can integrate the acquired set of assets with their processes would help preparers to focus their analysis on what has been acquired, rather than on how a market participant could potentially integrate the acquired assets.

31. Consequently, we support Proposal 2.

Proposal 3: The fair value of the assets acquired is concentrated in an asset

32. The FASB decided that a set of assets is not considered a business if substantially all of the fair value of the gross assets acquired (including any acquired intangible asset that is not identifiable) is concentrated in a single identifiable asset or group of similar identifiable assets. If this threshold is met, the set of assets would not be a business and an entity does not need to consider the guidance to determine whether the set includes a substantive process (ie the additional guidance in Proposal 1).

33. This proposal requires an entity to compare the fair value of the single asset acquired (or group of similar assets) with the fair value of the gross assets acquired rather than with the total consideration paid or net assets. This is to avoid creating the result that the existence of debt (for example, a building with a mortgage loan) or other liabilities could alter the analysis and result in too many sets of assets not meeting the definition of a business.

34. The FASB decided that the threshold could be met even if the fair value is concentrated in a group of similar identifiable assets (ie not only when the fair value is concentrated in a single asset). If an entity acquires, for example, ten similar buildings and other assets, the entity should compare the fair value of the ten buildings acquired with the fair value of the gross assets acquired and determine whether the threshold is met.

35. The FASB also decided to provide guidance on what could be considered a single asset, or a group of similar asset, for purposes of applying the threshold. In particular, the FASB decided that the following should not be combined into a single asset or considered similar assets:

(a) tangible and intangible assets;

(b) identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development);

(c) financial and non-financial assets;

(d) different major classes of financial assets (for example, cash, accounts

(e) receivable, and marketable securities); and

(f) different major classes of tangible non-financial assets (for example, inventory and manufacturing equipment).

Staff views on Proposal 3

36. We think that Proposal 3 would help preparers, because many participants to the PIR of IFRS 3 asked the IASB to clarify when the acquired set of assets should not be considered as a business.

37. In our view, Proposal 3 is a good practical expedient and IFRS preparers should be comfortable in applying it, because the term 'substantially all' is already used in many IFRSs, such as IAS 17, IAS 23, IFRS 9, IFRS 10, IFRS 15, etc.

38. We agree that an entity should compare the fair value of the asset acquired with the fair value of the gross assets acquired rather than with the total consideration paid or the net assets acquired, because otherwise too many transactions could be considered as asset acquisitions.

39. We think that this practical expedient should be used even when a group of similar identifiable assets is acquired. In theory, we agree that if the acquisition of a building plus an ancillary service (eg cleaning service) is considered an asset acquisition, the acquisition of ten similar buildings plus the ancillary service (eg cleaning service) should be considered an asset acquisition as well.

40. Consequently, we support Proposal 3.

Proposal 4: Revise the definition of outputs

41. Paragraph B7 of IFRS 3 defines output as follows:

> 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.

42. The FASB decided to narrow the definition of outputs to focus on goods and services to customers. This is the proposed amendment:

> Output. The result of inputs and processes applied to those inputs that provide goods or services to customers, other revenues, or investment income, such as dividends or interest ~~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~~.

43. The FASB decided that the definition of output should not include returns in the form of lower costs or other economic benefits directly to investors or other owners, members, or participants, because many asset acquisitions (eg the purchase of new equipment for a manufacturing facility) may lower costs.

Staff views on Proposal 4

44. We think that Proposal 4 would help IFRS preparers, because many participants in the PIR of IFRS 3 think that the current definition of a business is too broad.

45. In our view, the proposal to limit the definition of output to the ability to provide goods or services to customers and to generate other types of revenues would help to distinguish between an asset acquisition and a business combination.

46. We agree that the current reference to 'return in the form of dividends, lower costs, or other economic benefits' is too broad and that many asset acquisitions may lower costs or provide other economic benefits.

47. We note that many participants to the PIR of IFRS 3 think that the term 'capable of' in the current definition of a business is too broad. The FASB decided to

narrow the definition of outputs and to retain the term ‘capable of’ in the definition of a business. We think that the decision to revise the term ‘output’ (together with Proposal 1) would narrow the definition of a business. Consequently, we agree that it is not necessary to change/clarify the term ‘capable of’ in the definition of a business.

48. We also think that retaining the term ‘capable of’ would help when an entity acquires a supplier, because after the transaction the supplier might cease generating revenues, if, for example, all output is consumed by the acquirer. We think that the supplier would still be ‘capable of’ generating revenues, and so it should qualify as a business.

49. On the basis of the analysis above we support Proposal 4.

Proposal 5: Adding examples

50. The FASB decided to add examples to help with the interpretation of what is considered a business and to illustrate how to apply the new guidance.

51. In each of the examples, the first step of the analysis is the evaluation of the threshold described in Proposal 3. If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not a business. If that threshold is not met, an entity would evaluate whether the set includes an input and a substantive process that together contribute to the ability to create outputs. Whether both an input and a substantive process are included in the set is evaluated using the guidance in Proposal 1.

52. We report in Appendix A of this paper a preliminary draft of the examples developed by FASB. These examples are the same as those included in the FASB staff paper on the definition of a business for the September 2015 joint IASB/FASB meeting (AP 13C).

Staff views on Proposal 5

53. We think that the proposed examples would help preparers in understanding the amendments proposed by the FASB and how the proposed guidance should be applied. Many participants in the PIR of IFRS 3 asked the IASB to provide more guidance on how to interpret the definition of a business.

54. In our view, the proposed examples are a good way to ensure that IASB members agree with the outcomes of the proposed guidance.

55. We think that the elements of a business (inputs, processes, and outputs) can vary significantly from industry to industry. Consequently, in our view, the proposed examples may be beneficial to preparers and auditors, because they illustrate what types of processes give rise to a business in some of the industries that we learnt from our PIR have experienced the greatest challenges with applying the definition of a business.

56. We also think that the wording of some of the examples developed by FASB may need to be modified to ensure that the proposed examples will not be inconsistent with other IFRSs. We report in Appendix B our proposed edits to Case A.

57. Consequently, we support Proposal 5.

Proposal 6: Prospective application

58. The FASB decided that an entity would be required to apply the proposed amendments prospectively to any transaction that occurs on or after the effective date.

Staff views on Proposal 6

59. We agree that proposed amendments should be applied prospectively, because the retrospective application of these proposal would be costly and impracticable in most situations. A retrospective approach would require an entity to go back and analyse all of its acquisitions of both assets and businesses to re-evaluate the new definition and its accounting effect.

IASB Decisions

60. In October 2015, the IASB discussed the FASB's proposals described above and decided:

    (a) to propose changes to IFRS 3 that are the same as the amendments proposed by FASB; and

    (b) to include these amendments in an Exposure Draft.

61. During the October 2015 IASB meeting, some IASB members asked whether the proposed amendments would help solve the practical issues that had been raised to the IFRS IC about the definition of a business.

Issues raised to the IFRS IC – Staff analysis

62. In May 2013 the IFRS IC discussed a list of issues on the definition of a business that had been identified by the Staff from outreach activities to preparers, industry sector groups and the large accounting and auditing firms. For further details on the work performed by the IFRS IC on this issue, see Agenda Paper 6A[2] for the May 2013 IFRS IC meeting.

63. In May 2013 the IFRS IC decided that the list of issues should be contributed to the PIR of IFRS 3. In the table below we report the issues identified by the Staff in 2013 and our views on whether the new proposals respond to those issues.

Issues	**Staff comments**

[2] The paper can be found here: http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/May/AP06A%20-%20WIP%20-%20Definition%20of%20a%20business%20-%20Summary%20of%20outreach%20results%20and%20analysis.pdf

Issues	Staff comments
What types of processes give rise to a business? Views differ on whether and when the acquisition of a single significant asset, for example an investment property or a vessel, with some simple processes associated with it, gives rise to a business combination.	This issue is addressed by Proposals 1 and 3. Only substantive processes give rise to a business.
What inputs and processes that the seller used in operating the business, or that a market participant needs to operate the business, have to be included in the acquired set, because otherwise it is not considered a business? What inputs and processes that the seller used in operating the business, or that a market participant needs to operate the business, might be missing or excluded from the acquired set for it nevertheless to be considered a business? This issue is particularly relevant in an asset-based industry such investment property or shipping.	This issue is addressed by Proposals 1, 2 and 3. Substantive processes have to be included in the acquired set of assets. We propose deleting the requirement of the assessment of a market participant's ability to replace the missing elements. The proposed threshold should be very useful for asset-based industries.
How do you consider employees in the assessment of whether an acquired set constitutes a business? This issue is relevant, if the acquirer does not take over all of the workforce that the seller used in operating the business, but instead replaces it by its own workforce or outsources these activities to external third-party providers.	This issue is addressed by Proposal 1. The acquired workforce shall perform a substantive process if the set does not produce outputs. An organised workforce might not be required if the acquired set produces outputs before and after the transaction.

Issues	**Staff comments**
How do you consider redundant assets, inputs and processes (ie assets, inputs and processes that are included in the acquired set but that the acquirer does not intend to use) in the assessment of whether an acquired set constitutes a business? The issue is whether and when redundant assets, inputs and processes give rise to a business if a market participant is capable of conducting and managing the integrated set as a business because of the redundant assets, inputs and processes?	This issue is addressed by Proposals 1 and 2. We propose deleting the requirement of the assessment of a market participant's ability to replace the missing elements.
How do you consider inputs and processes that have been outsourced or that are rendered by external third-party providers in the assessment of whether an acquired set constitutes a business?	This issue is addressed by Proposals 1and 5. Only substantive processes give rise to a business. The acquired outsourcing agreements may be considered to provide an organised workforce. However, in the circumstances in which the set does not produce outputs, and in which the workforce performs a substantive process, the entity would need to consider whether it controlled the substantive process.
What output gives rise to a business? There are divergent views on whether: (i) any type of output that is created by the acquired set gives rise to a business; or (ii) only specific types of outputs are relevant for this classification, for example only the output intended by the acquirer gives rise to a business.	This issue is addressed by Proposal 4. We propose narrowing the definition of outputs to goods or services provided to customers.

Issues	Staff comments
When are processes applied to inputs capable of creating output? There is diversity in views on whether capability requires that a project is technically feasible and economically viable or whether technical feasibility is sufficient;	This issue is addressed by Proposal 1, 3 and 5. We propose specific guidance when the acquired set does not have outputs. The proposed threshold could be useful, because an R&D project can be considered a single asset.
When does an integrated set of activities and assets in the development stage qualify as a business? There are divergent views on whether and when: (i) the acquisition of an upstream oil or gas or mining operation in the exploration and evaluation phase or development and construction phase constitutes a business combination; and on whether and when (ii) the acquisition of a pharmaceutical R&D project constitutes a business.	This issue is addressed by Proposals 1, 3 and 5. We propose specific guidance when the acquired set does not have outputs. The proposed threshold could be useful, because an R&D project can be considered a single asset.
How do you identify inputs, processes and outputs when they are closely interrelated? Some noted difficulties, for example, in classifying an acquired property management contract as being either an input or a process or both.	This issue is addressed by Proposals 1 and 5. The additional guidance on substantive processes and the examples proposed should help in identifying inputs and substantive processes even if they are interrelated.
When does goodwill indicate that a particular set of activities and assets is a business? Some noted difficulties, for example, because goodwill recognised in a business combination may arise in large parts as a result of recognising deferred tax assets and liabilities.	This issue is addressed by Proposal 1. The presence of goodwill is a strong indicator that the acquired set of assets is a business. However, we propose to specify that a negligible amount of goodwill does not necessarily mean that the set is a business.

64. On the basis of the analysis above, we think that the proposed amendments to IFRS 3 would help solve the issues that had been raised to the IFRS IC about the definition of a business.

Questions to the IFRS Interpretations Committee members
1. Do you agree that the proposed amendments to IFRS 3 would help address the issues that had been raised to the IFRS IC about the definition of a business?
2. Do you have any comments on the proposed amendments to IFRS 3?
3. Do you have any comments on the draft examples in Appendix A of this paper?
4. Do you have any comments on our proposed edits to Case A in Appendix B of this paper?

Appendix A – Draft examples developed by FASB

> > > Case A: Acquisition of Single-Family Homes

805-10-55-52 ABC acquires, renovates, leases, sells, and manages single-family residential homes. ABC acquires a portfolio of 10 single-family homes that each have at-market in-place leases. The only elements included in the acquired set are the 10 single-family homes and the 10 in-place leases. Each single-family home includes the land, building, and property improvements. Each home has a different floor plan, square footage, lot, and interior design.

805-10-55-53 ABC first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. ABC must first determine whether each single-family home would be considered a single asset for purposes of this analysis. ABC concludes that the land, building, and property improvements can be considered a single asset in accordance with paragraph 805-10-55-9B. That is, the building and property improvements are attached to the land and cannot be removed without incurring significant cost. However, the in-place lease is an intangible asset and cannot be combined with the tangible real estate in accordance with paragraph 805-10-55-9C.

805-10-55-54 ABC then considers whether the 10 tangible assets (the combined land, building, and property improvements) are similar. Each home is different; however, the nature of the assets (all single-family homes) are similar. As such, ABC concludes that the group of 10 single-family homes is a group of similar assets.

805-10-55-55 Next, ABC compares the fair value of the group of similar tangible assets with the fair value of the total gross assets acquired (the combined tangible assets plus the 10 in-place lease assets) and concludes that substantially all of the fair value of the gross assets acquired is concentrated in the group of similar tangible assets. That is, the inplace leases in this Example do not have significant fair value. As such, the set is not a business.

> > > Case B: Acquisition of a Drug Candidate

805-10-55-56 Pharma Co. purchases from Biotech a legal entity that contains the rights to a Phase 3 compound being developed to treat diabetes (the in-process research and development project). Included in the in-process research and development project is the historical know-how, formula protocols, designs, and procedures expected to be needed to complete the related phase of testing. The legal entity also holds an at-market clinical research organization contract and an at-market clinical manufacturing organization contract. The clinical research organization contract provides services in which the vendor performs certain research and development activities that are part of the current phase of the research and development activities required by the U.S. Food and Drug Administration. The clinical manufacturing organization contract provides access to some of the necessary materials to perform those activities. No employees, other assets, or other activities are transferred.

805-10-55-57 Pharma Co. first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. Pharma Co. concludes that the in-process research and development project is an identifiable intangible asset that would be accounted for as a single asset in a business combination. Pharma Co. also concludes that there is no fair value associated with the clinical research organization contract and the clinical manufacturing organization contract. Therefore, all of the consideration in the transaction would be allocated to the in-process research and development project. As such, Big Pharma concludes that substantially all of the fair value of the gross assets acquired is concentrated in the single in-process research and development asset and the set is not a business.

> > > Case E: Acquisition of Biotech

805-10-55-67 Pharma Co. buys all of the outstanding shares of Target Biotech. Target Biotech's operations include research and development activities on several preclinical compounds that it is developing (in-process research and development projects). The set includes the scientists that have the necessary skills, knowledge, or experience to perform research and development activities. In addition, Target Biotech has long-lived tangible assets such as a corporate headquarters, a research lab, and testing equipment. Target Biotech does not yet have a marketable product and, therefore, has not generated revenues.

805-10-55-68 Pharma Co. first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. The identifiable assets in the set include multiple in-process research and development projects and tangible assets (the corporate headquarters, the research lab, and the lab equipment). In addition, Pharma Co. concludes that there is fair value associated with the acquired workforce. Pharma Co. also concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets. Furthermore, because of the significant amount of fair value associated with both the tangible assets and the acquired workforce, Pharma Co. does not assess whether the in-process research and development projects are similar (because even if those projects were similar, the threshold would not be met).

805-10-55-69 Because the set does not have outputs, Pharma Co. evaluates the criteria in paragraph 805-10-55-5A to determine whether the set has both an input and a substantive process. Big Pharma concludes that the criteria in paragraph 805-10-55-5A are met because the scientists make up an organized workforce that has the necessary skills, knowledge, or experience to perform processes that, when applied to the in-process research and development inputs, is critical to the ability to develop those inputs into a good that can be provided to a customer. The presence of a more than insignificant amount of goodwill is another indicator that the workforce is performing a critical process. Thus, the set includes both inputs and substantive processes and is a business.

> > > Case H: Acquisition of Corporate Office Building

805-10-55-76 REIT purchases all of the outstanding shares of Building Co. from Seller. Building Co. holds a multitenant corporate office park with six 10-story office buildings leased to maximum occupancy. Seller manages its properties centrally and manages the operations of Building Co. with its own employees.

805-10-55-77 As part of the transaction, REIT acquires the land, buildings, and in-place leases and assumes vendor contracts for outsourced cleaning and security. Seller's employees that perform leasing (sales, underwriting, and so forth), tenant management, financing, and other strategic management processes are not included in the set. REIT plans to replace the property management and employees with its own internal resources.
805-10-55-78 REIT first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. Although the leases are at market value, REIT concludes that the fair value of the in-place leases are significant and that the fair value of the gross assets acquired is not concentrated in either the leases or the tangible assets.

805-10-55-79 The set has continuing revenues through the in-place leases and, therefore, has outputs. As such, REIT must consider the criteria in paragraph 805-10-55-5B to determine whether the set includes both an input and a substantive process that together contribute to the ability to create outputs.

805-10-55-80 REIT concludes that the criterion in paragraph 805-10-55-5B(a) is not met because the processes performed through the cleaning and security contracts (the only process acquired) would be considered ancillary or minor in the context of all the processes required to create outputs in the real estate industry. That is, while those outsourcing agreements may be considered to provide an organized workforce that performs cleaning and security processes when applied to the building, the processes performed by the cleaning and security personnel would not be considered critical in the context of all the processes required to create outputs.

805-10-55-81 REIT also concludes that the criterion in paragraph 805-10-55-5B(b) is not met because the cleaning and security processes could be easily replaced with little cost, effort, or delay in the ability to continue producing outputs. While the cleaning and security processes need to be completed to continue the operation of the buildings, these contracts can be replaced quickly with little effect on the ability to continue producing outputs.

805-10-55-82 REIT concludes that the criterion in paragraph 805-10-55-5B(c) is not met because the cleaning and security contracts are not considered unique or scarce. That is, these types of arrangements are readily accessible in the marketplace.

805-10-55-83 Because none of the criteria were met, REIT concludes that the set does not include both an input and substantive processes that together contribute to the ability to create outputs and therefore is not considered a business.

> > > Case I: Acquisition of Corporate Office Building
805-10-55-84 Assume the same facts as in Case H except that the set includes the employees responsible for leasing, tenant management, and managing and supervising all operational processes, such as the cleaning and security vendors.

805-10-55-85 REIT evaluates the criteria in paragraph 805-10-55-5B and concludes that the criterion in paragraph 805-10-55-5B(a) is met because the set includes an organized workforce that performs processes critical to the ability to continue producing outputs when applied to the acquired inputs in the set, such as the land, building, and in-place leases (that is, REIT concludes that the leasing, tenant management, and supervision of the operational processes are critical to the creation of outputs). Because only one criterion in paragraph 805-10-55-5B needs to be met, the set includes both an input and substantive processes that together contribute to the ability to create outputs and is considered a business.

Appendix B – Our proposed edits to Case A

We are proposing the edits below to clarify that the in-place lease is considered a separate asset only for the evaluation of the threshold described in Proposal 3. If the set is a business, the acquirer shall continue to apply paragraph B42 of IFRS 3, which states that the acquirer includes the lease in the measurement of the leased property and so the lease is not recognised separately.

> > > Case A: Acquisition of Single-Family Homes

1 ABC acquires, renovates, leases, sells, and manages single-family residential homes. ABC acquires a portfolio of 10 single-family homes that each have at-market in-place leases. The only elements included in the acquired set are the 10 single-family homes and the 10 in-place leases. Each single-family home includes the land, building, and property improvements. Each home has a different floor plan, square footage, lot, and interior design.

2 ABC first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. ABC must first determine whether each single-family home would be considered a single asset for purposes of this analysis. ABC concludes that the land, building, and property improvements can be considered a single asset in accordance with paragraph 805-10-55-9B. That is, the building and property improvements are attached to the land and cannot be removed without incurring significant cost. However, the in-place lease ~~**is an intangible**~~ **shall be considered as a separate** asset and cannot be combined with the tangible real estate **for the purpose of evaluating whether substantially all of the fair value is concentrated in a single identifiable asset** ~~**in accordance with paragraph 805-10-55-9C**~~.

3 ABC then considers whether the 10 tangible assets (the combined land, building, and property improvements) are similar. Each home is different; however, the nature of the assets (all single-family homes) are similar. As such, ABC concludes that the group of 10 single-family homes is a group of similar assets.

4 Next, ABC compares the fair value of the group of similar tangible assets with the fair value of the total gross assets acquired (the combined tangible assets plus the 10 in-place lease assets) and concludes that substantially all of the fair value of the gross assets acquired is concentrated in the group of similar tangible assets. That is, the inplace leases in this Example do not have significant fair value. As such, the set is not a business.

Appendix C – IFRS 3 requirements on the definition of a business

Application guidance

Definition of a business

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.

Basis for Conclusions

Definition of a business

BC15 The definition of a business combination in the revised standards provides that a transaction or other event is a business combination only if the assets acquired and liabilities assumed constitute a business (an acquiree), and Appendix A defines a *business*.

BC16 SFAS 141 did not include a definition of a business. Instead, it referred to EITF Issue No. 98-3 *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business* for guidance on whether a group of net assets constitutes a business. Some constituents said that particular aspects of the definition and the related guidance in EITF Issue 98-3 were both unnecessarily restrictive and open to misinterpretation. They suggested that the FASB should reconsider that definition and guidance as part of this phase of the project, and it agreed to do so. In addition to considering how its definition and guidance might be improved, the FASB, in conjunction with the IASB, decided that the boards should strive to develop a joint definition of a business.

BC17 Before issuing IFRS 3, the IASB did not have a definition of a business or guidance similar to that in EITF Issue 98-3. Consistently with the suggestions of respondents to ED 3, the IASB decided to provide a definition of a business in IFRS 3. In developing that definition, the IASB also considered the guidance in EITF Issue 98-3. However, the definition in IFRS 3 benefited from deliberations in this project to that date, and it differed from EITF Issue 98-3 in some aspects. For example, the definition in IFRS 3 did not include either of the following factors, both of which were in EITF Issue 98-3:

(a) a requirement that a business be self-sustaining; or

(b) a presumption that a transferred set of activities and assets in the development stage tha planned principal operations cannot be a business.

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.

BC19 The boards also considered whether to include in the revised standards a presumption similar to the one in EITF Issue 98-3 that an asset group is a business if goodwill is present. Some members of the FASB's resource group suggested that that presumption results in circular logic that is not especially useful guidance in practice. Although the boards had some sympathy with those views, they noted that such a presumption could be useful in avoiding interpretations of the definition of a business that would hinder the stated intention of applying the revised standards' guidance to economically similar transactions. The presumption might also simplify the assessment of whether a particular set of activities and assets meets the definition of a business. Therefore, the revised standards' application guidance retains that presumption.

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.

BC21 SFAS 141(R) amends FASB Interpretation No. 46 (revised December 2003) *Consolidation of Variable Interest Entities*(FASB Interpretation 46(R)) to clarify that the initial consolidation of a variable interest entity that is a business is a business combination. Therefore, the assets, liabilities and non-controlling interests of the variable interest entity should be measured in accordance with the requirements of SFAS 141(R). Previously, FASB Interpretation 46(R) required assets, liabilities and non-controlling interests of variable interest entities that are businesses to be measured at fair value. The FASB concluded that variable interest entities that are businesses should be afforded the same exceptions to fair value measurement and recognition that are provided for assets and liabilities of acquired businesses. The FASB also decided that upon the initial consolidation of a variable interest entity that is not a business, the assets (other than goodwill), liabilities and non-controlling interests should be recognised and measured in accordance with the requirements of SFAS 141(R), rather than at fair value as previously required by FASB Interpretation 46(R). The FASB reached that decision for the same reasons described above, ie if SFAS 141(R) allows an exception to fair value measurement for a particular asset or liability, it would be inconsistent to require the same type of asset or liability to be measured at fair value. Except for that provision, the FASB did not reconsider the requirements in FASB Interpretation 46(R) for the initial consolidation of a variable interest entity that is not a business.