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STAFF PAPER

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CMAC Meeting

Project	Definition of a business		
Paper topic	CMAC feedback on the Exposure Draft		
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Introduction

1. In June 2016, the International Accounting Standards Board (the Board) published the Exposure Draft *Definition of a Business and Accounting for Previously Held Interests* (the ED) (ED/2016/1). The aim of the ED is to clarify the definition of a business and the related application guidance in IFRS 3 *Business Combinations*.

Purpose of this session

2. The purpose of this session is to obtain CMAC members' feedback on one of the main proposals included in the ED.

3. In this paper, we:

   (a) summarise the current accounting requirements for business combinations and purchases of assets;

   (b) explain the screening test proposed in the ED;

   (c) present an example to illustrate the accounting consequences of the proposed screening test; and

   (d) ask CMAC members whether they find the accounting outcomes of the proposed screening test useful.

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Summary of current requirements

4. An entity shall determine whether a transaction is a business combination by applying the definition of a business and the related application guidance in IFRS 3.

5. The Appendix A of IFRS 3 includes the following definition of 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.

6. According to paragraph B7 of IFRS 3, a business consists of inputs and processes applied to those inputs that have the ability to create outputs. Paragraphs B7-B12 of IFRS 3 provide guidance to determine whether an acquired set of assets meets the definition of a business.

7. Defining a business is important, because the financial reporting requirements for the acquisition of a business are different from the requirements for the purchase of a group of assets that does not constitute a business

Asset purchase accounting

8. If the assets acquired are <u>not</u> a business, as defined by IFRS 3, the acquirer shall account for the transaction as an asset purchase. This means that:

   (a) the transaction is recognised at cost,

   (b) the total cost shall be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase;

   (c) acquisition-related costs are capitalised as part of the cost of the assets;

   (d) deferred tax assets and deferred tax liabilities are not recognised;

   (e) such a transaction does not give rise to goodwill;

   (f) there is no specific guidance on the accounting for contingent consideration; and

   (g) there are no specific disclosure requirements.

Business combination accounting

9. If the assets acquired are a business, as defined by IFRS 3, the acquirer shall account for the transaction as a business combination. This means that:

   (a) the transaction is recognised at fair value;

   (b) identifiable assets acquired and liabilities assumed are measured at their acquisition date fair values;

   (c) acquisition-related costs are expensed;

   (d) deferred tax assets and deferred tax liabilities arising from the initial recognition of assets and liabilities are recognised on the acquisition date;

   (e) goodwill (or a gain from a bargain purchase) is recognised;

   (f) contingent consideration is recognised at fair value; and

   (g) there are specific disclosure requirements (eg the primary reasons for the business combination, the amounts recognised for each major class of assets, the combined entity's revenue and profit or loss for the period as if the acquisition date had been as of the beginning of the period, etc…)

The concerns we are responding to

10. We heard through the post-implementation review (PIR) of IFRS 3 that stakeholders find it challenging in some circumstances to determine whether a set of assets and activities acquired is a business or a group of assets. Some respondents to the PIR commented that the definition of a business is too broad, citing a number of specific examples from the application guidance in the Standard that contribute to this. One such example is the use in the Standard of the phrase 'capable of being conducted as a business'. We heard that these concerns about the guidance can make it difficult to distinguish between an asset deal and a business combination.

11. The concern about the definition of a business being too broad was noted in particular in specific industries, such as real estate, extractive, pharmaceutical,

technology and shipping. For example, is the purchase of a piece of vacant land in the centre of a city 'capable' of being used as a car park, in which case would the Standard lead the purchaser to the conclusion that the transaction be classified as a business combination?

The screening test proposed in the ED

12. The Board proposed to provide a screening test that will make it simpler in some cases to determine, without further analysis, that a set of activities and assets acquired does not constitute a business. To achieve this, the Board proposed that a set of activities and assets shall not be considered a business if, at the transaction date, substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets.

13. The Board explained in paragraph BC19 of the ED that it decided to propose a determinative screening test, because it believes that this test will reduce the cost of applying the definition of a business. The Board expects that, usually, the fair value of a substantive process would be more than insignificant, even if an asset is not recognised for some or all of the acquired processes. In this circumstance, if the acquired set of activities and assets includes a substantive process, then the fair value of the gross assets acquired would not be concentrated in a single asset, or a group of similar assets. In other words, the screening test is expected, in most cases, to lead to the same conclusion as would be reached through an assessment of whether substantive processes have been acquired.

Responses received on the ED

14. Some respondents to the ED commented that the proposed screening test does not allow the exercise of judgement and may sometimes result in inappropriate conclusions. They are concerned that certain transactions that are currently (and appropriately) accounted for as business combinations would be classified as asset purchases because of the proposed screening test.

15. In the following example, we illustrate the accounting consequences of the proposed screening test. The fact pattern presented in the example is one that

respondents to the ED identified as one in which the conclusion reached by applying the proposed screening test might differ from the conclusion reached by applying the current Standard.

Example – Acquisition of a shopping mall

Fact pattern

16. An entity (Acquirer) purchases a fully-leased shopping mall for CU1,000 in cash. The acquired set of activities and assets include: building, leases, contracts for outsourced cleaning and security and the employees responsible for leasing, tenant management, and managing and supervising all operational processes. No other assets or liabilities are transferred.

17. According to the current requirements of IFRS 3, the building and the leases are considered as a single asset. The acquisition-date fair value of the building, taking into account the terms of the leases, is CU980[1]. The amount attributed to the building for tax purposes (the tax base) is CU450. The tax rate is 30%.

18. The fair value associated with the workforce transferred is CU50.

19. The fair value associated with the acquired contracts for cleaning and security is nil.

20. The acquisition-related costs amount to CU10.

Applying the proposed screening test

21. According to the screening test proposed in the ED, the transaction described in the fact pattern is not a business combination, because substantially all of the fair value of the gross assets acquired is concentrated in the building (ie the fair value of the building is 98% of the fair value of the gross assets acquired).

22. Consequently, the Acquirer accounts for the transaction as an asset purchase. This means that the Acquirer recognises the building (that is an investment property) at CU1,010. The acquired workforce is not an identifiable asset, thus

[1] In this Staff Paper, currency amounts are denominated in ‘currency units’ (CU).

the whole cost (including acquisition-related costs) is allocated to the building. The Acquirer recognises no other assets or liabilities. No specific disclosures are required for this transaction.

23. Assuming that before the transaction there were no other assets and liabilities, after the transaction the balance sheet of the Acquirer would be the following.

Acquirer Balance Sheet	
Investment properties	1,010
Equity	1,010

Not applying the proposed screening test

24. According to the current requirements, the transaction described in the fact pattern may be considered a business combination, because the Acquirer acquired an input (ie the building) and the processes that applied to the building have the ability to create outputs (ie the employees responsible for leasing, tenant management, and managing and supervising all operational processes). This means that the Acquirer:

    (a) recognises the building (that is an investment property) at CU980;

    (b) recognises a deferred tax liability of CU159 [CU159 = (CU980-CU450)*30%];

    (c) recognises goodwill of CU179 [CU179 = CU1,000 - CU980 + CU159];

    (d) expenses the acquisition-related costs (CU10); and

    (e) provides specific disclosures, for example the primary reasons for the business combination and a description of the factors that make up goodwill.

25. Assuming that before the transaction there were no other assets and liabilities, after the transaction the balance sheet of the Acquirer would be the following.

Acquirer Balance Sheet	
Goodwill	179
Investment properties	980

Total Assets	1.159
Deferred tax liabilities	159
Equity	1.000
Total Equity and Liabilities	**1.159**

The Acquirer will also provide the specific information in the notes, for example:

(a) the primary reasons for the business combination;

(b) the acquisition-date fair values of the identifiable assets and liabilities;

(c) the factors that make up goodwill; and

(d) the revenue and the profit of the Acquirer if the combination had taken place at the beginning of year.

Questions to CMAC members

1 Do you think that the proposed screening test would result in useful information for the example presented? Please explain your preference.

2 Do you have other comments on the consequences of the proposed screening test?