IFRS

STAFF PAPER

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IASB® meeting

Project	**Second Comprehensive Review of the *IFRS for SMEs*® Standard**
Paper topic	Towards an Exposure Draft—IFRS 3 *Business Combinations* (Definition of a Business and Reacquired Rights)
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Introduction

1. This paper discusses whether to propose amendments to the *IFRS for SMEs* Standard:

   (a) to introduce a rebuttable presumption when applying the definition of a business; and

   (b) to provide guidance on reacquired rights as set out in IFRS 3 *Business Combinations*.[1]

2. In this paper, the term SMEs refers to small and medium-sized entities that are eligible to apply the *IFRS for SMEs* Standard.

Purpose of the paper

3. The purpose of this paper is to ask the International Accounting Standards Board (IASB) to continue its discussion on aligning the *IFRS for SMEs* Standard with IFRS 3, following its December 2021 meeting, in particular:

[1] As part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree to use one or more of the acquirer's recognised or unrecognised assets (ie a pre-existing relationship). Examples of such rights include a right to use the acquirer's trade name under a franchise agreement or a right to use the acquirer's technology under a technology licensing agreement. A reacquired right is an identifiable intangible asset that the acquirer recognises separately from goodwill.

(a) to consider the recommendations of the SME Implementation Group (SMEIG) on two topics related to the alignment of Section 19 *Business Combinations and Goodwill* of the *IFRS for SMEs* Standard with IFRS 3; and

(b) to decide whether to propose amendments to the *IFRS for SMEs* Standard:

  (i) to introduce a rebuttable presumption when applying the definition of a business—so that if an acquired set of activities and assets has outputs, there is a rebuttable presumption that the set of activities and assets qualifies as a business at the acquisition date; and

  (ii) to provide guidance on reacquired rights, particularly the application guidance as set out in paragraphs B36 and B53 of IFRS 3.

Summary of staff recommendations

4. The staff recommend the IASB:

(a) propose aligning the definition of a business in the *IFRS for SMEs* Standard with the amended definition of a business issued in 2018, without introducing any rebuttable presumption (ie confirm the IASB's tentative decision from its December 2021 meeting).

(b) retain unchanged Section 19 of the *IFRS for SMEs* Standard for the improvements in IFRS 3 that provided additional guidance on reacquired rights (ie not provide guidance on required rights for SMEs).

Structure of the paper

5. This paper is structured into three sections as follows:

(a) rebuttable presumption for the definition of a business:

  (i) background (paragraph 7 of this paper);

  (ii) SMEIG recommendations (paragraphs 8–12 of this paper); and

  (iii) staff analysis (paragraphs 13–20 of this paper);

(b) guidance on reacquired rights:

(i) background (paragraphs 21–25 of this paper);

(ii) SMEIG recommendations (paragraphs 26–28 of this paper); and

(iii) staff analysis (paragraphs 29–31 of this paper); and

(c) staff recommendations and questions for the IASB (paragraph 32 of this paper).

6. Appendix A to this paper sets out the IASB's rationale in the Request for Information for views on aligning the *IFRS for SMEs* Standard with IFRS 3.

Rebuttable presumption for the definition of a business

Background

7. At its December 2021 meeting the IASB:

(a) considered all forms of feedback on the Request for Information *Comprehensive Review of the* IFRS for SMEs *Standard*, published in January 2020, and the recommendations of the SMEIG on the alignment of Section 19 of the *IFRS for SMEs* Standard with IFRS 3, including the 2018 definition of a business.[2]

(b) tentatively decided to propose amendments to Section 19 of the *IFRS for SMEs* Standard to align with parts of IFRS 3, including with the amended definition of a business issued in October 2018.[3] The proposals would include, in a new appendix to Section 19, application guidance that includes:

(i) the optional concentration test set out in paragraphs B7A–B7B of IFRS 3;

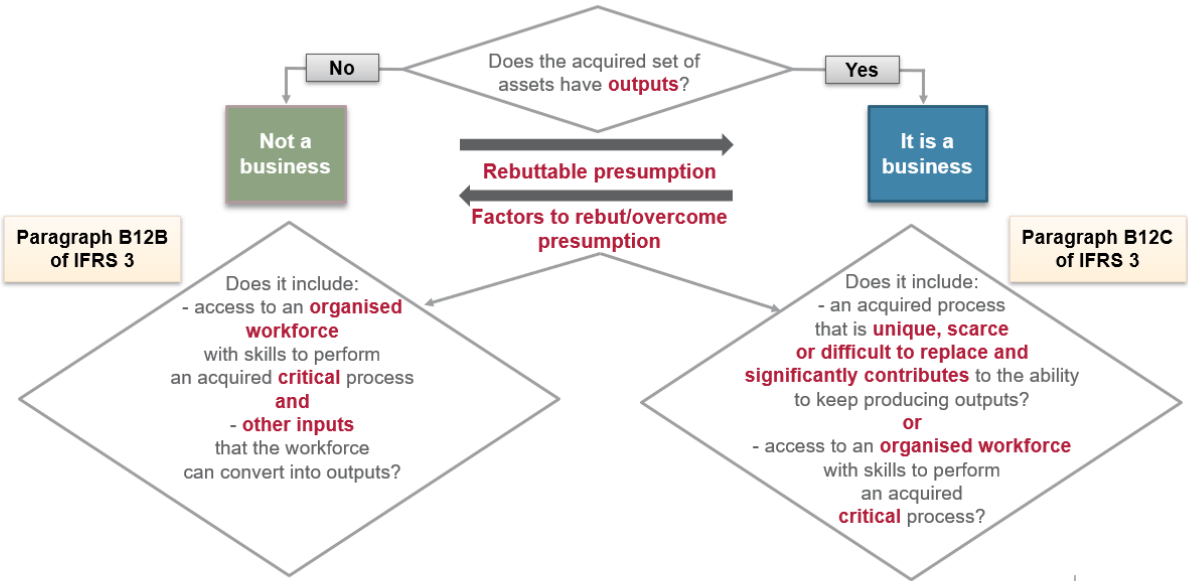
(ii) a decision tree to assess whether an acquired process is substantive; and

[2] For more detail see AP30A: Towards an Exposure Draft—IFRS 3 Business Combinations of the December 2021 IASB meeting.

[3] For more detail of the IASB's tentative decisions see IASB Update December 2021. A summary of the IASB's tentative decisions to date is at Agenda Paper 30 *Cover paper* of this meeting.

(iii) the application guidance for the assessment set out in paragraphs B8–B12D of IFRS 3, alongside some illustrative examples.

(c) asked the staff to explore introducing a rebuttable presumption in the *IFRS for SMEs* Standard (as a possible simplification) when applying the definition of a business—so that if an acquired set of activities and assets has outputs, there is a rebuttable presumption that the set of activities and assets qualifies as a business at the acquisition date. This presumption could be rebutted using the factors set out in paragraphs B12B and B12C of IFRS 3.



SMEIG recommendations

8. The SMEIG met on 21 January 2022 to develop recommendations to enable the IASB to decide whether—to propose amendments to Section 19 of the *IFRS for SMEs* Standard—to introduce a rebuttable presumption for the assessment of a business as set out in paragraph 7(c) of this paper.

9. Many SMEIG members said the IASB should not introduce the rebuttable presumption because:

(a) introducing such a presumption:

(i) could introduce complexity for SMEs; and

(ii) could impose excessive costs on SMEs.

(b) applying such a presumption could lead to inappropriate conclusions in several situations—in which case:

(i) it could raise implementation and application questions; and

(ii) it could lead to two different outcomes for the same fact pattern.

(c) applying such a presumption would be inconsistent with what are the 'minimum requirements to be a business' as set out in paragraph BC21F of the Basis for Conclusions on IFRS 3.[4]

(d) the definition of a business issued by the IASB in 2018 is more precise and is simpler for SMEs to apply than the rebuttable presumption would be—ie applying the 2018 definition of a business is straightforward in most cases.

10. In relation to paragraph 9(b) of this paper, one SMEIG member expressed concern about whether introducing the rebuttable presumption as a simplification might result in improper classification of some acquisitions, which would reduce the quality of information reported to SMEs' users.

11. Some SMEIG members said the IASB should introduce the rebuttable presumption because introducing such a presumption:

(a) would provide cost relief and maintain the *IFRS for SMEs* Standard's simplicity; and

(b) would help SMEs bypass some of the assessment steps.

12. One SMEIG member, who supported introducing the rebuttable presumption, expressed concern that applying the presumption in circumstances that leads to an incorrect outcome requires the SME to rebut it.

[4] Paragraph BC21F of the Basis for Conclusions on IFRS 3 explains that the existence of a process (or processes) is what distinguishes a business from a set of activities and assets that is not a business. Consequently, the IASB decided that to be considered a business, an acquired set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. The IASB incorporated this requirement in paragraph B8 of the IFRS 3.

Staff analysis

13. Paragraph 7(c) of this paper sets out a possible simplification to the assessment of a business—a rebuttable presumption for the assessment of a business: if an acquired set of activities and assets has outputs, there would be a rebuttable presumption that the set of activities and assets qualifies as a business at the acquisition date. To rebut the presumption an SME would use the factors set out in paragraphs B12B and B12C of IFRS 3.

14. Many SMEIG members expressed concerns about introducing this possible simplification for the reasons discussed in paragraphs 9–10 of this paper.

15. Paragraphs BC21A–BC21B of the Basis for Conclusions to IFRS 3 explains stakeholders' concerns raised during the post-implementation review of IFRS 3 about how to interpret and apply the definition of a business. To address those concerns, the definition of a business issued by the IASB in 2018 clarifies that, to be considered a business, an acquired set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs.

16. Paragraph BC21F of the Basis for Conclusions on IFRS 3 (see also footnote 4 of this paper), explains the existence of a process (not the existence of outputs) is what distinguishes a business from a set of activities and assets that is not a business—ie the minimum requirements to be a business.

17. To rebut the presumption discussed in paragraph 7(c) of this paper, an SME would need to perform the detailed assessment set out in paragraphs B12B and B12C of IFRS 3. Arguably there is no significant difference (nor cost relief) if an SME assesses whether an acquisition transaction is a business by using the aligned definition of a business (as amended in 2018), with or without such a rebuttable presumption because to rebut the presumption or consider whether to rebut the presumption the SME needs to make the assessment in paragraphs B12B and B12C of IFRS 3.

18. The staff think that introducing such a rebuttable presumption could lead to different outcomes for the same fact pattern—ie it may not faithfully represent the acquisition transaction. Although outputs are an element of a business, they are not required for an integrated set of activities and assets to qualify as a business. Also, the nature of the elements of a business varies by industry and structure of an entity's operations (activities). Adding the rebuttable presumption may:

    (a) force SMEs to account for an acquired set of activities and assets as a business combination—which might not be the case, if the set of activities and assets has outputs (ie real estate);[5] or

    (b) force SMEs to account for an acquired set of activities and assets as assets—which might not be the case, if the set of activities and assets does not have outputs (ie an early-stage entity).[6] [7]

19. Therefore, the staff believe that introducing such a rebuttable presumption could lead to an inappropriate recognition of goodwill and lead to structuring opportunities.

20. Taking into consideration recommendations of the SMEIG and the staff analysis, the staff do not recommend the IASB propose introducing in the *IFRS for SMEs* Standard the rebuttable presumption set out in paragraph 7(c) of this paper.

Reacquired rights

Background

21. Paragraph 94 of Agenda Paper 30A of the December 2021 IASB meeting mentioned that the staff:

    (a) will bring a paper at a future IASB meeting on whether Section 19 of the *IFRS for SMEs* Standard needs to provide guidance on reacquired rights as set out in IFRS 3, and

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[5] For more detail see Illustrative Examples, Examples A scenario 2 of IFRS 3.

[6] Paragraphs BC17–BC18 of the Basis for Conclusions on IFRS 3 explain that the IASB continue to exclude a presumption that an integrated set in the development stage that has not commenced planned principal operations cannot be a business.

[7] For more detail see Illustrative Examples, Example C of IFRS 3.

(b) will consult with the SMEIG members before bringing such a paper to the IASB.[8]

22. As set out in paragraph A9 of Appendix A to this paper, in the Request for Information the IASB did not seek views on aligning Section 19 of the *IFRS for SMEs* Standard with the requirements in IFRS 3:

(a) introducing the option to measure non-controlling interests at fair value;

(b) changing the recognition criteria for recognising an intangible asset acquired in a business combination;

(c) clarifying that an assembled workforce is not recognised as an intangible asset; and

(d) providing additional guidance on reacquired rights.

23. Although the IASB acknowledged that not aligning Section 19 with some parts of IFRS 3 would result in the *IFRS for SMEs* Standard diverging from the acquisition method of accounting required by IFRS 3 it considered this approach struck a balance between simplicity and faithful representation.

24. The IASB reasoned that goodwill acquired in a business combination is amortised over its useful life applying the *IFRS for SMEs* Standard. Consequently, intangible assets acquired in a business combination that are not recognised separately are amortised through the annual amortisation of goodwill. Therefore, it is less critical to separately recognise intangible assets with finite useful lives.

25. However, the staff wanted to assess whether the reacquired rights are common amongst SMEs—for example, in the retail industry such rights include a right to use the acquirer's trade name under a franchise agreement (see also footnote 1 of this paper).

[8] For more detail see AP30A: Towards an Exposure Draft—IFRS 3 Business Combinations of the December 2021 IASB meeting.

SMEIG recommendations

26. The SMEIG met on 21 January 2022 to develop recommendations to enable the IASB to decide whether—to propose amendments to Section 19 of the *IFRS for SMEs* Standard—to provide guidance on reacquired rights as set out in IFRS 3.

27. Overall SMEIG members recommended the IASB not introduce guidance on reacquired rights in the *IFRS for SMEs* Standard.

28. Many SMEIG members said reacquired rights are not common for SMEs. In contrast, some SMEIG members said reacquired rights are relevant to SMEs, but a small number of these SMEIG members expressed concern that accounting for such rights might introduce complexities for SMEs if the guidance is not simplified.

Staff analysis

29. As set out in paragraph 22 of this paper, Section 19 of the *IFRS for SMEs* Standard does not include guidance on reacquired rights. However, the staff wanted to assess whether the reacquired rights are common amongst SMEs, and particularly if the terms of the contract giving rise to a reacquired right are favourable or unfavourable relative to the terms of current market transactions for the same or similar items (as set out in paragraphs B36 and B53 of IFRS 3)—such that the acquirer shall recognise, separately from the business combination, a settlement gain or loss (to recognise settlement of pre-existing relationship).[9] If this is the case, introducing this guidance would fill a gap and could provide users of SMEs' financial statements with an improved understanding of the cost of the business combination if it is relevant to SMEs.

[9] Paragraph B52 of IFRS 3 provides guidance for measuring that settlement gain or loss, including the Illustrative Examples paragraphs IE54–IE56 of IFRS 3.

30. At its March 2021 meeting, the IASB tentatively decided to apply the alignment approach with IFRS Accounting Standards as the starting point in developing an exposure draft of proposed amendments to the *IFRS for SMEs* Standard. In doing so, the IASB agreed to apply three alignment principles—relevance to SMEs, simplicity and faithful representation (Agenda Paper 30 of this meeting outlines the IASB's alignment approach). If a topic is not relevant to SMEs then the IASB would not propose alignment of the *IFRS for SMEs* Standard with that topic in IFRS Accounting Standards. The analysis of the other two alignment principles 'simplicity' and 'faithful representation' would not be undertaken if the relevant principle is not met.

31. The recommendations of the SMEIG provide evidence that the topic is not relevant for SMEs in many jurisdictions (see the recommendations of the SMEIG in paragraphs 26–28 of this paper). Therefore, the staff consider that the topic is not relevant to SMEs and do not recommend the IASB introduce guidance on reacquired rights in the *IFRS for SMEs* Standard.

Staff recommendations and question for the IASB

32. Taking into consideration the recommendations of the SMEIG and the staff analysis, the staff recommend the IASB:

    (a) propose aligning the definition of a business in the *IFRS for SMEs* Standard with the amended definition of a business issued in 2018, without introducing any rebuttable presumption.

    (b) retain unchanged Section 19 of the *IFRS for SMEs* Standard for the improvements in IFRS 3 that provided additional guidance on reacquired rights (ie not to provide guidance on required rights for SMEs), on the basis that was set out in paragraph B63 of the Request for Information (reproduced in paragraph A9 of Appendix A to this paper).

Questions for the IASB

1. Does the IASB agree with the staff recommendation to confirm the IASB's tentative decision from its December 2021 meeting (ie propose aligning the definition of a business in the *IFRS for SMEs* Standard with the amended definition of a business issued in 2018, without introducing any rebuttable presumption)?
2. Does the IASB agree with the staff recommendation to retain unchanged Section 19 of the *IFRS for SMEs* Standard for the improvements in IFRS 3 that provided additional guidance on reacquired rights (ie not to provide guidance on required rights for SMEs)?

Appendix A—IASB rationale in the Request for Information on aligning the *IFRS for SMEs* Standard with IFRS 3 (2008)

A1. Question S5 asks for views on the extent to which Section 19 should be aligned with IFRS 3 (2008). Currently, Section 19 is based on IFRS 3 (2004), which was revised in 2008.

A2. The IASB decided not to align the requirements of Section 19 with IFRS 3 (2008) during the first comprehensive review of the *IFRS for SMEs* Standard because the requirements of Section 19 were working well in practice and adding new fair value measurement requirements would introduce unnecessary complexity.

A3. In deciding to reconsider alignment of Section 19 with IFRS 3 (2008) the IASB noted that it had completed the post-implementation review of IFRS 3 (2008) and had access to additional implementation experience regarding IFRS 3 (2008).

A4. The IASB noted that IFRS 3 (2008) was developed to address known deficiencies in the requirements of IFRS 3 (2004) and to address application problems with the Standard. The IASB decided to address alignment by applying the 'alignment principles' to the significant improvements introduced in IFRS 3 (2008).

A5. The *IFRS for SMEs* Standard does not include requirements on the accounting for step acquisitions. If Section 19 was aligned with the IFRS 3 (2008), requirements for step acquisitions an acquirer would be required to:

(a) measure the fair value of assets and liabilities acquired at the acquisition date and thereby determine the amount of goodwill at the acquisition date; and

(b) remeasure its previously held equity interest in the acquisition.

A6. Introducing requirements for step acquisitions based on IFRS 3 (2008) into Section 19 would improve comparability and provide better-quality information to users. In the absence of requirements in the *IFRS for SMEs* Standard, entities may apply other practices.

A7. The IASB decided to seek views, first, on the need to introduce requirements for step acquisitions into Section 19 and then on whether those requirements should be aligned with IFRS 3 (2008).

A8. The IASB is also seeking views on aligning Section 19 with IFRS 3 (2008) so that:

(a) acquisition-related costs are recognised as an expense at the time of the acquisition. Applying IFRS 3 (2008), acquisition-related costs are considered not to be part of the fair value exchange between the buyer and seller of the business combination and therefore are recognised separately as an expense.

(b) contingent consideration in a business combination is recognised at fair value and subsequent changes are accounted for as remeasurements of a financial instrument. Recognising contingent consideration at fair value would provide users of financial statements prepared applying the *IFRS for SMEs* Standard with better information about the cost of the business combination. The IASB also proposes to simplify these requirements and seek views on permitting an entity to use the undue cost or effort exemption in paragraph 2.14A of the *IFRS for SMEs* Standard and provide the related disclosures if measuring contingent consideration at fair value would involve undue cost or effort.

A9. The IASB is not seeking views on aligning Section 19 with improvements in IFRS 3 (2008) that:

(a) introduced the option to measure non-controlling interests at fair value;

(b) changed the recognition criteria for recognising an intangible asset acquired in a business combination;

(c) clarified that an assembled workforce is not recognised as an intangible asset; and

(d) provided additional guidance on reacquired rights.

A10. The IASB decided that these improvements would introduce complexity into Section 19. The IASB noted that its decision not to seek views on aligning Section 19 with these improvements would result in the *IFRS for SMEs* Standard diverging from the acquisition method of accounting required by IFRS 3 (2008).

A11. The acquisition method of accounting views a business combination from the perspective of the acquirer. Applying the acquisition method, users of financial statements are provided with relevant information to assess the initial investment made and the subsequent performance of those investments.

A12. The IASB acknowledged the divergence; however, the topics it had decided to seek views on should provide a balance between simplicity and faithful representation. Specifically, the IASB noted that:

(a) introducing requirements for acquisition-related costs to be recognised as an expense at the time of the acquisition and for contingent consideration in a business combination to be recognised at fair value would improve users' ability to understand the cost of the business combination. This approach would result in the amount of goodwill recognised more faithfully representing the underlying economics of the business combination.

(b) applying the *IFRS for SMEs* Standard, goodwill acquired in a business combination is amortised over its useful life similarly to any other intangible asset. Consequently, intangible assets that have not been separately recognised in the business combination will be accounted for through the annual amortisation charge for goodwill so that the split of items between intangible assets and goodwill has a less significant impact on the financial statements prepared applying the *IFRS for SMEs* Standard than it does under full IFRS Accounting Standards.