

IFRS Developments

IASB issues amendments to the definition of a business in IFRS 3

What you need to know

- ▶ The IASB issued narrow-scope amendments to IFRS 3 to help entities determine whether an acquired set of activities and assets is a business or not.
- ▶ The amendments clarify the minimum requirements to be a business, remove the assessment of a market participant's ability to replace missing elements, and narrow the definition of outputs.
- ▶ The amendments add guidance to assess whether an acquired process is substantive and add illustrative examples.
- ▶ The amendments introduce an optional concentration test to permit a simplified assessment.
- ▶ The amendments are effective for annual reporting periods beginning on or after 1 January 2020 and apply prospectively. Earlier application is permitted.

Highlights

In October 2018, the International Accounting Standards Board (IASB or Board) issued amendments to the definition of a business in IFRS 3 *Business Combinations*. The amendments are intended to assist entities to determine whether a transaction should be accounted for as a business combination or as an asset acquisition.

IFRS 3 continues to adopt a market participant's perspective to determine whether an acquired set of activities and assets is a business. The amendments: clarify the minimum requirements for a business; remove the assessment of whether market participants are capable of replacing any missing elements; add guidance to help entities assess whether an acquired process is substantive; narrow the definitions of a business and of outputs; and introduce an optional fair value concentration test. The Board also added examples to illustrate the application of the guidance in IFRS 3 on the definition of a business.

The Board expects that the amendments to IFRS 3 and the equivalent amendments made to US GAAP in 2017, will lead to more consistency in applying the definition of a business across entities applying IFRS and entities applying US GAAP.

The amendments to IFRS 3 are effective for annual reporting periods beginning on or after 1 January 2020 and apply prospectively. Earlier application is permitted.

Background

IFRS 3 establishes different accounting requirements for a business combination as opposed to the acquisition of an asset or a group of assets that does not constitute a business. Business combinations are accounted for by applying the acquisition method, which, among other things, may give rise to goodwill. In contrast, when accounting for asset acquisitions, the acquirer allocates the transaction price to the

individual identifiable assets acquired and liabilities assumed on the basis of their relative fair values and no goodwill is recognised.

Therefore, whether or not an acquired set of activities and assets is a business, is a key consideration in determining how the transaction should be accounted for. Prior to the amendments, IFRS 3 stated that a business consists of inputs and processes applied to those inputs that have the ability to create outputs, although outputs are not necessarily required for an integrated set to qualify as a business.

However, from the Post-implementation Review (PIR) of IFRS 3, the IASB learned that many stakeholders had concerns about how to interpret and apply the definition of a business. To address those concerns, the Board set out to clarify the definition of a business, with the objective of helping entities to determine whether a transaction should be accounted for as a business combination or as an asset acquisition.

Market participant's perspective

IFRS 3 adopts a market participant's perspective in determining whether an acquired set of activities and assets is a business. This means that it is irrelevant whether the seller operated the set as a business or whether the acquirer intends to operate the set as a business. Some respondents to the PIR of IFRS 3 noted that such a fact-driven assessment may not provide the most useful information, as it does not consider the business rationale, strategic considerations and objectives of the acquirer. However, the IASB decided not to make any changes in this respect, because an assessment made from a market participant's perspective and driven by facts (rather than the acquirer's intentions) helps to prevent similar transactions being accounted for differently. Also, the Board noted that bringing more subjective elements into the determination would likely have increased diversity in practice.

Overview of the main amendments

Minimum requirements to be a business

In the IASB's view, the existence of a process (or processes) is what distinguishes a business from a non-business. Consequently, the Board decided that to be considered a business, an integrated 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 output. It also clarified that a business can exist without including all of the inputs and processes needed to create outputs. That is, the inputs and processes applied to those inputs must have the 'ability to contribute to the creation of outputs' rather than the 'ability to create outputs'.

Market participant's ability to replace missing elements

Prior to the amendments, IFRS 3 stated that 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". The IASB, however, decided to base the assessment on what has been acquired in its current state and condition, rather than on whether market participants are capable of replacing any missing elements, for example, by integrating the acquired activities and assets. Therefore, the reference to such integration was deleted from IFRS 3. Instead, the amendments focus on whether acquired inputs and acquired substantive processes together significantly contribute to the ability to create outputs.

Assessing whether an acquired process is substantive

The PIR of IFRS 3 also revealed difficulties in assessing: whether the acquired processes are sufficient to constitute one of the elements of a business; whether any missing processes are so significant that an acquired set of activities and assets is not a business; and, how to apply the definition of a business when the acquired set of activities and assets does not generate revenue. In response, the IASB added guidance to help entities assess whether an acquired process is substantive. That guidance requires more persuasive evidence when there are no outputs, because

the existence of outputs already provides some evidence that the acquired set of activities and assets is a business.

The Board also reasoned that, although itself an input, the presence of an organised workforce is an indicator of a substantive process. This is because the 'intellectual capacity' of an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes (even if not documented) that are capable of being applied to inputs to create outputs.

The amendments to IFRS 3 specify that if a set of activities and assets does not have outputs at the acquisition date, an acquired process shall be considered substantive only if: (a) it is critical to the ability to develop or convert acquired inputs into outputs; and (b) the inputs acquired include both an organised workforce with the necessary skills, knowledge, or experience to perform that process and other inputs that the organised workforce could develop or convert into outputs. In contrast, if a set of activities and assets has outputs at that date, an acquired process shall be considered substantive if: (a) it is critical to the ability to continue producing outputs and the acquired inputs include an organised workforce with the necessary skills, knowledge, or experience to perform that process; or (b) it significantly contributes to the ability to continue producing outputs and either is considered unique or scarce, or cannot be replaced without significant cost, effort or delay in the ability to continue producing outputs.

The Board also added some clarifications to IFRS 3 to support these requirements, including that an acquired contract is not itself a substantive process. An acquired contract, such as a contract for outsourced property management or outsourced asset management, may however give access to an organised workforce.

Narrowed definition of outputs

Previously, outputs were defined as returns in the form of dividends, lower costs or other economic benefits provided directly to investors or other owners, members or participants. As part of the amendments to IFRS 3, the IASB narrowed the definition of outputs to focus on goods or services provided to customers, investment income (such as dividends or interest) or other income from ordinary activities. The definition of a business in Appendix A of IFRS 3 was amended accordingly.

According to the Board, the previous reference to lower costs and other economic benefits provided directly to investors did not help to distinguish between an asset and a business. For example, many asset acquisitions may be made with the motive of lowering costs but may not involve acquiring a substantive process. Therefore, this wording was excluded from the definition of outputs and the definition of a business.

Optional concentration test

Whilst applying the definition of a business might involve significant judgement, many respondents to the PIR of IFRS 3 noted that there was little or no guidance to identify situations where an acquired set of activities and assets is not a business. To address those concerns, the IASB introduced an optional fair value concentration test. The purpose of this test is to permit a simplified assessment of whether an acquired set of activities and assets is not a business. Entities may elect whether or not to apply the concentration test on a transaction-by-transaction basis.

The concentration test is met 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 test is based on gross assets, not net assets, as the Board concluded that whether a set of activities and assets includes a substantive process does not depend on how the set is financed. In addition, certain assets are excluded from the gross assets considered in the test. If the test is met, the set of activities and assets is determined not to be a business and no further assessment is needed. If the test is not met, or if an entity elects not to apply the test, a detailed assessment must be performed applying the normal requirements in IFRS 3. As such, the concentration test never determines that a transaction is a business combination.

Illustrative examples

In addition to the amendments described above, the Board provided a series of illustrative examples to help constituents to apply the guidance in IFRS 3 on the definition of a business. These illustrative examples accompany the standard and address, among other things, the application of the optional concentration test and the assessment whether an acquired process is substantive.

Convergence with US GAAP

IFRS 3 is the result of a joint project between the IASB and the Financial Accounting Standards Board (FASB) and previously contained the same definition of a business as US GAAP. Nonetheless, in practice, that definition was viewed as capturing a broader range of transactions under US GAAP than under IFRS. After a PIR of the equivalent US GAAP standard identified similar difficulties in applying the definition of a business as the PIR of IFRS 3, the FASB amended US GAAP in 2017 by issuing Accounting Standards Update No. 2017-01 *Clarifying the Definition of a Business*.

The amendments to IFRS 3, though worded differently, are based on conclusions similar to those reached by the FASB in its amendments to US GAAP. Consequently, the Board expects that these amendments will lead to more consistency in applying the definition of a business across entities applying US GAAP and entities applying IFRS. However, the amendments to IFRS and US GAAP differ in certain respects (e.g., the concentration test is optional under IFRS, but mandatory under US GAAP). These differences are discussed in the Basis for Conclusions on IFRS 3.

Effective date and transition

The amendments to IFRS 3 must be applied to transactions that are either business combinations or asset acquisitions for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2020. Consequently, entities do not have to revisit such transactions that occurred in prior periods. Earlier application is permitted and must be disclosed.

How we see it

Determining whether an acquired set of activities and assets is a business or not, could result in significantly different accounting outcomes, both at the date of acquisition (i.e., at initial recognition) and subsequently. The previous guidance on the definition of a business created some diversity in practice. Therefore, we welcome the IASB's clarifications and additional guidance on the definition of a business in IFRS 3.

Since the amendments apply prospectively to transactions or other events that occur on or after the date of first application, most entities will likely not be affected by these amendments on transition. However, entities considering the acquisition of a set of activities and assets after first applying the amendments should update their accounting policies on a timely basis.

Entities also need to be aware that the amendments could be relevant in other areas of IFRS. For example, the definition of a business may also be relevant where a parent loses control of a subsidiary and has early adopted *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to IFRS 10 and IAS 28), as issued in September 2014.

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