# STAFF PAPER

June 2017

## IASB® Meeting

| Project | Definition of a business |
|---|---|
| Paper topic | Analysis of the comments received on the remaining proposals included in the ED |

CONTACT(S) Leonardo Piombino lpiombino@fondazioneoic.it +39 06 6976 6834



## Introduction and Purpose of this paper

1. In June 2016, the Board published the Exposure Draft Definition of a Business and Accounting for Previously Held Interests (the ED) (ED/2016/1).

2. In January 2017, the US Financial Accounting Standards Board (FASB) finalised its project on this topic, by issuing the Accounting Standards Update 2017-01, *Clarifying the Definition of a Business* (the FASB ASU).

3. In April 2017, the Board discussed the comments received on the proposal to consider a set of activities and assets acquired not to be a business if the fair value of the gross assets acquired is concentrated in a single asset or group of similar assets. This proposal is sometimes called the 'screening test'. The Board tentatively decided to make the screening test optional on a transaction-by-transaction basis[1].

4. This paper analyses the feedback received on the other proposals included in the ED, which are:

   (a) Minimum requirements to be a business

   (b) Market participant capable of replacing missing elements

[1] For further details on the April 2017 Board's decisions see: https://s3.amazonaws.com/ifrswebcontent/2017/IASB/April/IASB-Update-April-2017.html#5

(c) Revised definition of output

(d) The definition of a business in Appendix A to IFRS 3

(e) Evaluating whether an acquired process is substantive

(f) Illustrative examples

(g) Goodwill

(h) Transition

(i) Convergence with the FASB ASU.

5. If the Board agrees with our recommendations listed in paragraphs 62-63 of this paper, we will present a comparison between the FASB ASU and our draft amendments to IFRS 3 at a future meeting. At that meeting, we will also ask the Board to confirm whether we have carried out all necessary due process steps and will ask permission to beginning drafting the final amendments.

## Minimum requirements to be a business

### *Board's proposal*

6. In the ED the Board proposed to clarify that to be a business a set of assets and activities must include, at a minimum, an input and a substantive process that together contribute to the ability to create outputs.

### *Feedback received*

7. Most respondents agreed with this proposal. A few respondents commented on this topic. One respondent observed that it is not clear which inputs and processes should be acquired in order to constitute a business. Another one suggested expanding the minimum elements of a business to include inputs that are required to contribute to the creation of outputs, but are not readily available. Comments received include the following:

(a) It is not clear to us which inputs and processes exactly would have to be acquired in order to constitute a business. In particular, the interaction of the statement that there is no longer a need for market participants to replace missing elements and the last sentence in B8, which states that "a business need not include all of the inputs or processes that the seller used in operating that business", is confusing, especially with regard to illustrative example D.[2] It is not fully clear to us how many inputs and/or processes would have to be included in the acquisition to constitute a business since the replacement of missing elements is no longer needed. It remains unclear whether the acquisition of parts of a business are to be considered a business acquisition or an asset acquisition, since some inputs or processes can be missing and do not have to be replaced[3].

(b) It is doubtful whether the acquired set has the ability to contribute to the creation of outputs, if the missing elements include inputs that are required to contribute to the creation of outputs, but are not readily available. Conversely, if all of the inputs needed to create outputs are readily available, it is less important whether or not the entity acquires at least one of those inputs from the seller. Therefore, the IASB should consider expanding the minimum elements of a business to include inputs that are required to contribute to the creation of outputs, but are not readily available[4].

### *Staff response*

8. We think that it would be impossible to specify which inputs and processes should be acquired in order to constitute a business, because determining what inputs and processes contribute to the ability to create outputs varies from industry to industry and from entity to entity. We also think that making a distinction between inputs that

[2] Example D addresses a temporarily closed manufacturing facility

[3] See CL9 Accounting Standards Committee of Germany.

[4] See CL29 Singapore Accounting Standards Council.

are readily available and inputs that are not readily available would add unnecessary complexity to the minimum requirements to be a business.

9. In order to address the comments received on this matter, the FASB decided to clarify in its ASU that an input and a substantive process together are required to contribute **significantly** to the ability to create outputs. We agree with adding the term “significantly”, because this would highlight that the acquired process must be important to the ability to create output.

## Market participant capable of replacing missing elements

### *Board’s proposal*

10. In the ED, the Board proposed to remove from paragraph B8 of IFRS 3 the statement that a set of activities and assets is a business if market participants can replace the missing elements and continue to produce outputs. The Board also decided that the evaluation of an acquired set should continue to be performed from a market participant’s perspective as stated in paragraph B11.

### *Feedback received*

11. Most respondents agreed with this proposal. A few respondents commented on this proposal. They stated that the wording of paragraph B8 might be considered inconsistent with the wording of paragraph B11. Comments received include the following:

    (a) We note that the ED retains the reference to 'market participant' in paragraph B11 of IFRS 3. We understand this reference is to market participants in general. This is because it is used in the context of clarifying that, when assessing whether an acquired set of activities and assets is a business, it is not relevant whether the specific seller operated the set as a business or whether the specific acquirer intends to do so. However, we understand that some may interpret the wording 'by a market participant' in paragraph B11 to be inconsistent with a definition of a business that focuses on the 'ability to contribute to the creation of outputs', irrespective of whether it is conducted or managed as a business by a particular market participant. We therefore suggest deleting the words 'by a market participant' in the first sentence of paragraph B11. This change would also highlight the importance of the fact-driven nature of this assessment, irrespective of the assessor's own circumstances (including those of a specific market participant)[5].

(b) In paragraph B8, it is suggested that term “in the opinion of a market participant” may be included in following manner to make it consistent with para B11:

“…. To constitute a business, an integrated set of activities and assets must include, in the opinion of a market participant, at a minimum, an input and a substantive process that together have the ability to contribute to the creation of outputs.”[6]

***Staff response***

12. We think that paragraph B8 is consistent with paragraph B11. We report below both paragraphs as amended in the ED.

> 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.~~ <u>To constitute a business, an integrated set of activities and assets must include,</u>

[5] See CL76 European Financial Reporting Advisory Group (EFRAG).

[6] See CL27 Securities and Exchange Board of India (SEBI).

> at a minimum, an input and a substantive process that together have the ability to contribute to the creation of outputs. However, a business need not include all of the inputs or processes that the seller used in operating that business.
>
> B11 Determining whether a particular set of activities and 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.

13. According to paragraph B8 of the ED, the acquirer would no longer assess whether some market participants can integrate the acquired assets to continue to produce outputs. This is because the assessment should be based on what has been acquired, rather than on how a market participant could potentially integrate the acquired assets.

14. This is consistent with paragraph B11 of the ED, which requires an assessment of whether the set is a business from a market participant's perspective, without considering the intentions of the acquirer.

15. Both paragraphs require an assessment only of what has been acquired. The intentions of the acquirer and the ability to integrate the acquired activities and assets are not relevant in determining whether the transaction is a business combination.

## Revised definition of output

### *Board's proposal*

16. In the ED, the Board proposed to narrow the definition of output to focus on goods and services provided to customers, investment income or other revenues. The definition of output proposed in the ED excludes returns in the form of lower costs and other economic benefits provided to investors, other owners, members or participants.

### *Feedback received*

17. Most respondents agreed with the revised definition of output. A few respondents asked the Board to clarify the term “other revenues” as part of the definition of outputs. They noted that the term “other revenues” may create diversity in practice, because the term can be applied and interpreted in various ways[7].

18. Comments received on this topic include the following:

    (a) The definition of outputs should also include cost reductions and other efficiencies that may arise as a result of a business acquisition[8].

    (b) The IASB should clarify what types of other economic benefits could be considered 'other revenues' and why such 'other revenue' would meet the definition of output[9].

    (c) The term “to customers” should be removed to permit accounting of businesses acquired for the purpose of captive consumption[10].

### *Staff response*

19. We think that the definition of outputs should not include cost reductions and other efficiencies arising from a business combination, because (as explained in paragraph BC15 of the ED) many asset purchases (eg the purchase of new equipment) may lower costs even though they do not involve the acquisition of activities and processes. Thus, including cost reductions does not help in distinguishing between an asset and a business, because it confuses motivations for the acquisition with an assessment of the characteristics of the assets (and activities) acquired.

20. The acquisition of a set of assets for the purpose of captive consumption is addressed in paragraph BC17 of the ED, which explains that an acquired set of assets that is integrated by the acquirer and no longer generates (external) revenues after the

[7] See CL66 [Canadian] Accounting Standards Board (AcSB).

[8] See CL8 CPA Australia.

[9] See CL79 Hong Kong Institute of Certified Public Accountants (HKICPA)

[10] See CL27 SEBI.

transaction is considered as a set of assets that has output. We think that the Board should move this statement into the body of the amendments. We think that this statement would be not consistent with FASB ASU because paragraph 805-10-55-5E states that:

> When the set has outputs (that is, there is a continuation of revenue before and after the transaction), the set …

21. We think that:

    (a) the term “other revenues” means revenues that are outside the scope of IFRS 15 *Revenue from Contracts with Customers*. IFRS 15 defines revenue as ‘income arising in the course of an entity’s ordinary activities’. IFRS 15 pplies to all contracts with customers, except contracts within the scope of other Standards (mainly IFRS 16 *Leases*, IFRS 4 [IFRS 17] *Insurance Contracts*, IFRS 9 *Financial Instruments*) and except for some non-monetary exchanges between entities in the same line of business;

    (b) the term “goods and services provided to customers” refers to revenues within the scope of IFRS 15.

22. In our view, the Board should clarify the meaning of “other revenues” amending the wording of paragraph B7(c) of the ED along the lines suggested below (additions to the ED are shown in bold):

> (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~~ <u>goods or services to customers, investment income (such as dividends or interest) or other</u> <u>~~**revenues**~~</u> <u>**income arising from contracts that are within the entity’s ordinary activities but are not within the scope of IFRS 15**</u>.

23. This clarification is not included in the FASB’s definition of output. However, we think that this is just a clarification and not a difference that could cause divergence in practice, because paragraph BC59 of the FASB ASU states that:

BC59. The Board decided to narrow the definition of outputs by aligning it with the ability to generate goods or services provided to customers. That is consistent with how outputs are discussed in Topic 606, which describes goods or services that are an output of the entity's ordinary activities. However, the Board noted that not all entities have revenues within the scope of Topic 606 and, therefore, decided to incorporate other types of revenues in the definition. For example, the Board decided to include the reference to investment income in the definition of outputs in the amendments in this Update to ensure that the purchase of an investment company can still qualify as a business combination.

## The definition of a business in Appendix A to IFRS 3

### *Board's proposal*

24. In the ED, the Board did not propose any amendments to the current definition of a business in Appendix A of IFRS 3. The current definition is the following:

> 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.

25. In the ED, the Board proposed to amend the definition of outputs in paragraph B7 as follows:

> A business consists of inputs and processes applied to those inputs that have the ability to ~~create~~ <u>contribute to the creation of</u> outputs. Although businesses usually have outputs, outputs are not required for an integrated set <u>of activities and assets</u> 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,~~ <u>contribute to the creation of</u> 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~~ contribute to the creation of outputs. Examples include strategic management processes, operational processes and resource management processes. These processes typically are documented, but the intellectual capacity of 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~~ goods or services to customers, investment income (such as dividends or interest) or other revenues.

### *Feedback received*

26. Some respondents noted that the definition of a business in Appendix A to IFRS 3 is not consistent with the definition proposed in paragraph B7 of the ED. Some suggested the Board should amend the definition of a business in Appendix A to IFRS 3 to be consistent with the proposed amendments to paragraph B7 of the ED. Others suggested that the definition in Appendix A should point to the paragraphs where business is defined (ie paragraphs B7-B12C).

### *Staff response*

27. We agree that the definition of a business in Appendix A of IFRS 3 is inconsistent with paragraph B7 of the ED, which proposed a narrower definition of outputs.

Consequently, we think that the Board should amend the definition of a business in Appendix A of IFRS 3 as follows (additions to the ED are shown in bold):

> 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~~ goods and services to customers, investment income (such as dividends or interest) or other revenues**.
>
> [If the Board agrees to the recommendation in paragraph 22, we would replace **other revenues** with **other income arising from contracts that are within the entity's ordinary activities but are not within the scope of IFRS 15**]

28. We note that this would be inconsistent with the FASB ASU, because the FASB decided not to change the definition of a business, we report below paragraph BC60 of the FASB ASU.

> BC60. Some stakeholders suggested that the Board consider aligning the purpose of a business in paragraph 805-10-55-3A with the definition of an output because it is aligned in current GAAP. The Board considered aligning the terms in redeliberations; however, the Board decided that the definition of an output does not change the stated purpose of a business. Paragraph 805-10-55-3A establishes that a business consists of activities and assets and the purpose of those assets and activities, which is to provide a return. The Board observed that providing a return to its investors is what distinguishes a business from a nonprofit activity and indicated that aligning the guidance in that paragraph with goods or services could create additional confusion. In addition, the language in paragraph 805-10-55-3A on the types of returns makes clear that both investor-owned entities and other entities such as mutual entities can be considered a business. Finally, the Board noted that paragraph 805-10-55-3A does not conflict with the rest of the guidance because it specifically states that to be a business, the criteria in the rest of the guidance must be met.

29. We recomend that the Board should not add to the definition an explicit reference to the guidance in paragraphs B7-B12C. Our normal style is to keep the definitions concise, and provide guidance, without a cross-reference. Also, IFRS 3 paragraph 3 already contains both an explicit instruction to apply the definition of a business and an explicit cross-reference to paragraphs B7-B12. [The staff will update that cross-reference in drafting.]

## Evaluating whether an acquired process is substantive

### *Board's proposal*

30. The Board proposed that:

    (a) when the acquired set of activities and assets does not have outputs, the definition of a business is met only if the inputs acquired include both an organised workforce that performs a process that is critical to the creation of output and another input (or inputs) that is intended to be developed into outputs;

    (b) when the acquired set of activities and assets has outputs, the set is a business if either:

        (i) it includes a process that is considered unique or scarce, or cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs; or

        (ii) it includes an organised workforce that performs an acquired process that is critical to the ability to continue producing outputs.

### *Feedback received*

31. Most respondents supported the guidance on identifying a substantive process proposed by the Board. However, some respondents observed that the assessment of whether a substantive process exists may be complex to apply and highly judgemental. They recommended that the Board should simplify the guidance on

identifying a substantive process or provide additional examples on how to apply this new guidance. Comments received on this topic include the following:

(a) The acquisition of an organized workforce performing a critical process is a key factor in determining if an acquired set constitutes a business. However, we believe the assessment should consider not just the organized workforce but the functions performed by the organized workforce. This is an area where the principle and the examples as proposed seem inconsistent[11].

(b) We believe that the proposed guidance on determining whether an acquired process is substantive lacks sufficient clarity. While we agree that defining a substantive process across all entities may be difficult (BC22), we think that further guidance around what are typical characteristics of a substantive process would be useful[12].

(c) The terms process, substantive process, critical and unique or scarce are used at various points when describing the components necessary for a business, for example: B12A (no outputs) refers to a substantive process that is critical; whereas B12B (outputs) refers to a process (…) that is either unique or scarce (regardless of the presence of a workforce) or critical (if there is a workforce). We find this rules-based guidance complicated and confusing. We strongly recommend the IASB simplifies the definition of a substantive process and suggest that it is defined in paragraph B8 as critical to the ability to develop or convert inputs into outputs or one that is unique or scarce, or cannot be replaced without significant costs, effort or delay in the ability to continue producing outputs[13]

(d) … we believe that replacing a process will in many cases involve significant cost, effort, or delay. Therefore, in many

[11] See CL26 PWC.

[12] See CL54 EY.

[13] See CL65 The 100 Group.

cases it will not be necessary to have a unique or scarce process as the delay criterion will be fulfilled no matter whether a process is unique/scarce or not. We encourage the IASB to amend the tests:

(i) to turn the critical test into a simpler, more direct one of whether replacing the acquired workforce would cause significant cost, effort and delay in the production of output or the development of outputs. This would replace the current two stage test (testing the nature of the process and then testing the necessity of the workforce to that process) with a one-stage test (inferring the importance of the process from the difficulty in replacing the workforce). There would need to be an exception for difficulty etc. in replacing a workforce due to employment law, which has no connection to the concept of a business;

(ii) to require that a process cannot be replaced without significant cost, effort, and delay. If the "or" is replaced by an "and", then scarce and unique can and should be removed as separate criteria for two reasons. First, scarce and unique would be addressed by the amended wording, which introduces a higher hurdle. Second, scarce and unique are not defined and, therefore, could leave room for future debate.

This approach would also involve the simplification of a single formula – "cannot be replaced without significant cost, effort, and delay" – for both tests – workforce (that performs a process) and a process not involving a workforce[14].

### *Staff response*

32. One respondent believes that the assessment of whether a workforce is performing a substantive process should consider not just the organized workforce, but the

[14] See CL49 KPMG.

functions performed by the organized workforce. The respondent also believes that the principle and the examples seem inconsistent on this matter.

33. Paragraph B12A of the ED states that:

> If a set of activities and assets does not, at the acquisition date, have outputs (for example, it is an early-stage entity that has not started generating revenues), the set is a business only if it includes an organised workforce (which is an input) with the necessary skills, knowledge, or experience to perform an acquired substantive process (or group of processes)….

In our view, this paragraph clarifies that an organised workforce is an input and the required assessment includes an assessment of the functions performed by the workforce, because it requires assessing whether the workforce has the necessary skills to perform a substantive process. In other words, in order to assess whether the workforce has the necessary skills to perform a substantive process, the acquirer would need to assess the functions performed by the workforce. We also think that the examples are consistent with this paragraph, because in paragraphs IE88[15], IE101[16] and IE107[17] of the ED the purchaser concludes that the acquired set is a business, because the acquired workforce performs a substantive process and not solely because the acquired set include an organised workforce.

---

[15] IE88 states that:

"The set of activities and assets does not have outputs; thus, Purchaser applies the criteria in paragraph B12A. Purchaser concludes that the criteria in paragraph B12A are met, because the scientists are an organised 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. Thus, the set of activities and assets acquired includes both inputs and substantive processes and is therefore a business."

[16] IE101 states that:

"Purchaser concludes that the criterion in paragraph B12B(b) is met, because the set includes an organised workforce that performs processes (ie leasing, tenant management, and supervision of the operational processes) critical to the ability to continue producing outputs when applied to the acquired inputs (ie the land, buildings, and in-place leases). Consequently, the set of activities and assets acquired is a business."

[17] IE107 states that:

The set of activities and assets has outputs (interest revenue) arising from the loan portfolio. Consequently, Purchaser applies the criteria in paragraph B12B and concludes that the criterion in paragraph B12B(b) is met, because the set includes an organised workforce that performs processes (ie customer relationships management and credit risk management) that are critical to the ability to continue producing outputs when applied to the acquired inputs (ie financial assets). Consequently, the set of activities and assets acquired is a business.

34. As already mentioned above in this paper, we think that the typical characteristics of a substantive process varies from industry to industry and from entity to entity. Consequently, we think that the Board will not be able to provide further guidance on what the typical characteristics of a substantive process are.

35. A respondent believes that the proposed guidance in paragraph B12A and B12B should be simplified. Therefore, it suggested defining a substantive process as a process that is critical to the ability to develop or convert inputs into outputs or one that is unique, scarce, or cannot be replaced without significant costs, effort or delay in the ability to continue producing outputs.

36. The Board explained in paragraph BC26 of the ED that it believes that when an acquired set of assets does not include an organised workforce, more persuasive evidence is needed. Consequently, the acquired set must include both:

(a) outputs[18]; and

(b) a process that is 'unique, scarce or is difficult to replace' and not merely 'critical'. ('critical' is intended to be a lower threshold than 'unique, scarce or difficult to replace'[19]).

For this reason, the Board proposed the term 'unique, scarce or difficult to replace' in paragraph B12B(a) (ie when an organised workforce is not acquired) and the term 'critical' in paragraphs B12A and B12B(b) (ie when an organised workforce is acquired).

37. We do not support the definition of a substantive process suggested by the respondent (paragraph 35), because we think that this suggestion does not distinguish between

[18] As explained in paragraph BC23 the Board proposed two similar but distinct tests of acquired processes depending on whether the acquired set of activities and assets has outputs. This is because when outputs are not yet being created, the importance of the required elements of a business (ie inputs and processes) to the assessment is greater. For this reason, a set that does not have outputs must include an organised workforce to be a business.

[19] Paragraph BC26 of the ED states that:The Board believes that processes that are unique or scarce are usually valuable and this would often indicate that a process is substantive; consequently, the ED does not require that an organised workforce is one of the inputs acquired when a unique or scarce process is acquired. In contrast, some critical processes may not be unique or scarce, but widely available; consequently, it is necessary that an organised workforce with the necessary skills to perform that critical process is also acquired in order to conclude that the transaction is a business combination

acquisitions that include a workforce and acquisitions that do not. In our view, when the acquired set does not include a workforce a narrower test is needed.

38. Paragraph B12A of the ED states that a set that does not have outputs is a business only if:

    (a) it includes a workforce,

    (b) the acquired workforce is able to perform an acquired substantive process and

    (c) that acquired substantive process is critical to the ability to develop or convert another acquired input into outputs

39. We understand that one respondent suggested to replace the tests described in paragraph 38(b) and (c) above, with the test of whether replacing the acquired workforce would cause significant cost, effort and delay in the production or the development of outputs.

40. We think that assessing whether replacing the acquired workforce would cause significant cost, effort and delay in the development of outputs is a way (but not the only way) to assess whether the acquired workforce performs a substantive process that is critical to develop output. In addition, we are not convinced that the suggested assessment would always lead to the same outcome as the tests described in paragraph 38(b) and (c) above, nor that it would be simpler in all circumstances. Consequently, we think that the Board should not replace the guidance proposed in the ED with the assessment suggested by the respondent. However, we think that the Board should specify in the final amendments that difficulty in replacing a workforce may indicate that the workforce performs a substantive process. This clarification is not included in the FASB ASU.

41. We also understand that, in the respondent’s view, a process that is “unique or scarce” cannot be replaced without significant cost, effort, and delay. The respondent therefore suggests removing the “unique or scarce” criterion. We do not support this suggestion, because we think that sometimes it might be easier to assess the “unique or scarce” criterion than assessing costs, efforts and delays.

## Additional guidance on acquired outsourcing agreements

### *Board's proposal*

42. In the ED, the Board proposed to clarify that an acquired contract is not a substantive process. However, an acquired contract may give access to an organised workforce, for example a contract for outsourced property management or outsourced asset management. The Board proposed that an entity should assess whether an organised workforce accessed through such a contractual arrangement performs a substantive process that the entity controls, and thus has acquired (for example, considering the duration and the renewal terms of the contract).

### *Feedback received*

43. Respondents generally agreed with this proposal. However, some respondents asked the Board to clarify the guidance provided in paragraph B12C on acquired outsourcing agreements. Comments received on this topic include the following:

    (a) The role of acquired contracts in the various parts of the assessment process warrants further clarification. Paragraph B12C states that an acquired contract is not a substantive process in itself but may provide access to an organised workforce and thus control over a substantive process. Some interpret this to mean that only an acquired contract giving access to an organised workforce can be taken into account in the assessment of the process. This conclusion is supported by the arguments in paragraph IE91 of Example F. However, this would mean that, for example, an acquired contract which gives unopposable access to an automated critical process would be ignored in the business assessment, even if that process is one which would satisfy the criteria of B12B(a). This would not always be the correct conclusion, in our view[20].

[20] See CL32 BusinessEurope.

(b) We welcome the guidance provided in B12C on how to determine, in the case that an acquired contract gives access to an organised workforce, whether the acquirer has control over the organised workforce. However, it is a difficult area of judgement, where diversity in practice is observed and we are concerned that the guidance might not be sufficient to allow stakeholders to exercise their judgement. We recommend the IASB to provide an example to illustrate how this guidance can be applied[21].

(c) We support the IASB's proposal to include guidance on outsourced workforce and to treat it similarly to any other workforce acquired. As such we recommend stating in paragraph B12C that an outsourced workforce is a workforce and so the workforce test applies in the normal way[22].

### *Staff response*

44. One respondent observed that under the proposals in the ED, an acquired contract would be regarded as the acquisition of a substantive process only if the acquired contract gives the acquirer access to an organised workforce. Thus, if an acquired contract gives access to an automated process that is unique or scarce or difficult to replace, that contract would not be regarded as giving the acquirer control of a substantive process, even if the acquired set of assets and activities has outputs.

45. We think that when the acquired set does not include a workforce but includes an acquired contract that gives the acquirer control of a process, that process should be regarded as substantive only if the process is unique, scarce or difficult to replace. In our view, it is unlikely that an automated process that is unique, scarce or difficult to replace would be acquired through an acquired outsourcing agreement for the whole useful life of the process. Therefore, if the Board wished to add guidance on this point, it might also need to consider how the assessment would work for a contractual right to use an acquired process for only part of the useful life of the process. We

[21] See CL17 Accountancy Europe .

[22] See CL49 KPMG.

consider that developing guidance on this matter would involve effort disproportionate to the likely benefits for stakeholders, and could have unintended consequences. Consequently, we think that the Board should not provide additional guidance on this matter. This issue is not addressed explicitly in the FASB ASU.

46. We support the suggestion to illustrate in an example how the guidance on outsourcing agreements can be applied. This clarification might create some differences with FASB examples.

47. We do not support the suggestion to specify that an outsourced workforce is like an acquired workforce to assess whether a substantive process has been acquired. This is because we think that when a process is performed by an outsourced workforce the acquirer needs to assess whether it, rather than the outsourcing provider, controls the process performed by the outsourced workforce. This additional assessment, which may require significant judgement, is not necessary when a process is performed by the employee of the acquirer. Consequently, in our view, according to paragraph B12C of the ED, an outsourced workforce is like an acquired workforce only if the acquirer controls, and thus has acquired, the process performed by the outsourced workforce. We think that paragraph B12C of the ED is sufficiently clear on this point.

48. The proposed guidance on outsourcing agreements in the FASB ED was very similar to the guidance in the IASB ED. However, in its redeliberations, the FASB decided that, when outputs are not present, the acquired set of assets would need to include an organised workforce that is made up of employees. However, according to the ED issued by the IASB, an outsourced workforce may perform a substantive process even if the acquired set of assets has no output. We think that we should not change this proposal, because respondents to the IASB ED generally supported this proposal.

## Illustrative examples

### *Board's proposal*

49. The ED included eleven examples to illustrate the application of the proposed amendments.

### *Feedback received*

50. Most respondents expressed overall support for the illustrative examples included in the ED. However, some respondents suggested that the examples should be improved. Some respondents suggested the Board should further align the wording of the examples with the wording of FASB's examples. Others asked the IASB to provide additional examples. Some respondents provided specific drafting comments in order to help in clarifying the understandability and consistency of the examples. Comments received include the following:

    (a) We note that the understanding of 'input', 'process' and 'output' either do not seem to be clear, or the terms are apparently not understood in the same way. This again becomes particularly evident when applying the amendments to the examples included in the ED. For instance, we do not understand why the IASB feels that illustrative example C did not contain an output or why there was no input in illustrative example D. ... We believe that it would be helpful if, in each of the examples, the IASB explained what the Board believes the inputs, processes and outputs to be in order to facilitate a uniform understanding of these terms[23].

    (b) Example A, H and I: All these examples appear to analyse acquisitions of groups of real estate assets. It is difficult to understand the differentiating factors between these examples and to pin point the primary reason for different conclusions being reached[24].

    (c) It is not clear from Example C whether the set of activities and assets acquired generated revenue before the acquisition. Members believe it should be clarified whether the assertion that the set of activities and assets does not have outputs is an assumption in the set-up of this example, and be stated as such, or instead is the application of the entity's judgement, which should be stated and addressed in the analysis of this

[23] See CL9 ASCG.

[24] See CL50 The South African Institute of Chartered Accountants (SAICA).

example. If it is the application of judgement, then members suggest the IASB add language to explain the basis for this judgement[25].

(d) We are particularly concerned with Example D (acquisition of a manufacturing facility). It is difficult to support the conclusion that the set of activities and assets purchased is not a business just because the facility is temporarily closed down. Although the facility is 'not currently producing outputs' it nonetheless presumably retains the 'the ability to contribute to the creation of outputs' as it seems that it could be reopened at any time. Moreover, we are concerned that the conclusion reached in this example could encourage entities to arrange for a temporary shutdown of soon to be acquired facilities immediately before concluding the acquisition in order to ensure that the transaction is accounted for as an asset purchase rather than a business combination[26].

### *Staff response*

51. We agree that the fact patterns of the illustrative examples need some clarifications, in particular we think that the Board should clarify the assumptions (ie inputs and processes acquired and whether the acquired set has outputs or not) of each examples.

52. We also think that the Board should align the wording of the illustrative examples with the wording of FASB's examples whenever is possible in order to limit divergence in practice.

## Goodwill

### *Board's proposal*

53. The Board proposed to remove from paragraph B12 the presumption that the presence of goodwill indicates that the acquired set of activities and assets is a business. This is

[25] See CL61 IOSCO.

[26] See CL24 ICAEW.

because the Board believes that an entity may be willing to pay an insignificant premium for an asset or an assembled group of assets in some cases. Consequently, in the ED the Board proposed to specify that the presence of an insignificant amount of goodwill does not mean that the acquired assets should automatically be considered a business.

### *Feedback received*

54. Most respondents agreed with this proposal. A few respondents commented on this topic. They stated that the presence of goodwill as a separate indicator may not be consistent with the new guidance on substantive process. They suggested various solutions, for example: clarify this potential inconsistency, delete the reference to the presence of goodwill as a separate indicator. Comments received include the following:

    (a) The IASB should clarify how the assessment of this indicator interacts with the rest of the guidance, both when the set of activities have outputs or do not have outputs. For example, it is not clear what the conclusion would be if there is a goodwill but no output. The IASB should also clarify how the goodwill is determined for purposes of assessing this indicator. For example, goodwill could arise primarily from deferred tax liabilities that would be recognised in a business combination. But those deferred tax liabilities, even if significant, would not reflect the value of substantive processes. Another example would be a bargain purchase giving rise to negative goodwill; we wonder how the goodwill indicator would be assessed in this situation[27].

    (b) We recommend that the reference to the presence of goodwill as an indicator that an acquiree constitutes a business be deleted as we do not believe it is consistent with the more detailed discussion of substantive processes in proposed paragraphs B12A-C. This test has limited conceptual merit.

[27] See CL17 FEE.

The determination of whether goodwill is present is, from a practical point of view, performed after the determination of whether a transaction is a business combination and its use as an indicator that an acquiree is a business is therefore circular. This is particularly evident in the acquisition of single-asset entities (for example, a wrapper company holding a single property) as the decision on whether a transaction is a business combination will then determine whether a deferred tax asset or liability is recognised. This distinction between accounting for a business combination compared to an asset acquisition is, for such transactions, often the primary factor which determines whether an excess of consideration over net assets acquired (i.e. calculated 'goodwill') exists. In addition, factors other than the presence of 'goodwill' can affect this calculation – for example, the value of equity instruments delivered as consideration can be affected by a variety of factors unrelated to the transaction itself (for example, the share price of entities in the extractives industry is significantly affected by daily movements in commodity prices), meaning that 'goodwill' could be calculated due to a change in value between agreeing the number of equity instruments and the date of acquisition when there is, conceptually, no goodwill in the acquiree[28].

(c) We agree that the presence of more than an insignificant amount of goodwill may indicate that an acquired process is substantive. However, we consider that the discussion of the presence of goodwill may cause confusion if considered as a separate indicator in addition to the two sets of indicators. It could also lead to a counterintuitive outcome, for example when the presence of goodwill arises primarily from deferred tax liabilities. We therefore recommend that the first two

[28] See CL58 DTTL.

sentences of paragraph B12 are moved to the Basis for Conclusions[29].

### *Staff response*

55. Paragraph B12 of the ED states that:

> …When evaluating whether a set of activities and assets includes a substantive process, the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive and the set of activities and assets is a business. However, a business need not have goodwill. Paragraphs B12A–B12C provide a framework to assist an entity in evaluating whether the set of activities and assets includes a substantive process…

We think that according to paragraph B12 of the ED the presence of goodwill is just an indicator that a substantive process exists and that, whether or not goodwill is present, an entity should apply the guidance in paragraphs B12A-B12C to conclude on whether a business has been acquired.

56. We also think that the testing for the presence of more than an insignificant amount of goodwill is not an additional step of the analysis. The intent is only to provide another indicator to assist entities in assessing whether a substantive process has been acquired.

57. However, in the light of the comments received, we think that this additional indicator may create more confusion than benefits. Consequently, we think that the Board should remove from paragraph B12 the statement that the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive. This removal would not be consistent with FASB ASU.

[29] See CL76 EFRAG.

## Transition

58. Respondents generally agreed with the Board's proposal that an entity would not be required to apply the proposed amendments to transactions that occur before the effective date of the amendments.

## Convergence with FASB proposals

### *Board's proposal*

59. The Board and the FASB reached substantially converged tentative conclusions on how to clarify and amend the definition of a business. However, the wording of the Board's proposals is not fully aligned with the FASB's proposals.

### *Feedback received*

60. Most respondents encouraged the IASB and the FASB to reach converged solutions on their respective proposed amendments and use similar (or the same) wording wherever possible (including having the same examples) in order to avoid divergence in practice. A few respondents stated that differences between IFRS Standards and US GAAP may be justified, if the IASB's amendments result in a more appropriate model for IASB's constituents. Comments received on this issue include the following:

    (a) Overall, we think that financial statement users around the world are seeking a common language when reading financial statements. We think that common financial reporting will help to facilitate efficient capital markets, increase investor confidence and potentially reduce the cost of capital. From that perspective, we encourage the IASB and the FASB to, whenever possible, seek high-quality solutions that will result in more comparable financial reporting outcomes in the U.S. and globally… Accordingly, we recommend that both Boards: (a) use the same wording when they both make amendments to achieve the same objective; and (b) explain in their respective Basis for Conclusions documents their intentions as to whether or not a difference in application is expected when requirements differ in their respective standards[30].

(b) Members recommend the wording of the IASB's proposals be aligned with the FASB's proposals to the extent that the IASB and the FASB reached converged conclusions[31].

(c) We note that the FASB's amendments to US GAAP are in the context of how the definition of a business has been interpreted for US reporting purposes. Consequently, because the application of the definition of a business under IFRS has typically been different, it is possible that the amendments to US GAAP will not be entirely appropriate from an IFRS perspective. … GAAP differences may be fully justified, if the result is that the IASB's amendments result in a more robust model from the perspective of its global constituents[32].

(d) We believe that the differences in wording between the proposals of the IASB and FASB are not significant and will not create divergence in practice and inconsistent financial information[33].

### *Staff response*

61. We think that in the lights of the comments received the Board should try to minimize the differences in the requirements and should use similar (or identical) wording whenever possible. However, this does not mean that the Board should ignore the suggestions received from respondents only because those suggestions would lead to a difference in the requirements. In our view, convergence with the FASB ASU is an important factor to consider when assessing whether to accept or reject a comment, but should not be a determinative factor.

[30] See CL66 AcSB.

[31] See CL43 AOSSG.

[32] See CL73 BDO.

[33] See CL56 CINIF.

## Staff recommendations

62. On the basis of the analysis above, we recommend that the Board should reaffirm the following proposals included in the ED:

    (a) to remove the statement that a set of activities and assets is a business if market participants can replace missing elements and continue to produce outputs (paragraphs 10-15);

    (b) to revise the definition of outputs to remove the reference to the ability to reduce costs (paragraph 19);

    (c) to add guidance to help entities to assess whether a substantive process has been acquired and to provide two different sets of criteria to consider in this assessment, depending on whether the acquired set of assets has outputs (paragraphs 30-37);

    (d) to add examples to help with the interpretation of what is considered a business (paragraph 49);

    (e) that an entity would not be required to apply the proposed amendments to transactions that occur before the effective date of the amendments[34] (paragraph 58);and

    (f) to add guidance on outsourcing agreements and that this guidance should be applied even if the acquired set of activities and assets does not have outputs[35] (paragraphs 42-48).

63. We also recommend that the Board should:

    (a) clarify 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 are required to contribute **<u>significantly</u>** to the ability to create outputs[36] (paragraphs 6-9);

[34] All the recommendations from (a) to (e) are consistent with FASB ASU.

[35] This is not consistent with FASB ASU.

[36] This is consistent with FASB ASU.

(b) clarify that an acquired set of assets that is integrated by the acquirer and no longer generates revenues after the transaction is considered as a set of assets that has output when assessing whether a substantive process has been acquired[37] (paragraph 20);

(c) clarify in the definition of "output" that "other revenues" means other income arising from contracts that are within the entity's ordinary activities but are not within the scope of IFRS 15[38] (paragraphs 21-23);

(d) align the definition of a business in Appendix A of IFRS 3 with the revised definition of outputs in paragraph B7 of IFRS 3[39] (paragraphs 24-29);

(e) specify in the guidance on whether an acquired process is substantive that difficulties in replacing an acquired workforce may indicate that the workforce performs a substantive process[40] (paragraphs 38-40);

(f) to illustrate in an example how the guidance on outsourcing agreements can be applied[41](paragraph 46);

(g) clarify the fact patterns of the illustrative examples including the assumptions (ie inputs and processes acquired and whether the acquired set has outputs or not) of each examples[42] (paragraphs 51-52);

remove from paragraph B12 the statement that the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive[43] (paragraphs 53-57).

| **Question for the Board members** |
| --- |
| Do Board Members agree with the staff recommendations listed in paragraphs 62 and 63 of this paper? |

[37] We think that this clarification is not consistent with the FASB ASU.

[38] This clarification is not included in the FASB ASU.

[39] This is not consistent with FASB ASU.

[40] This clarification is not included in the FASB ASU.

[41] This might create some differences with FASB illustrative examples

[42] This might create some differences with FASB illustrative examples.

[43] This is not consistent with FASB ASU.