STAFF PAPER

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IASB Meeting

Project	Definition of a business
Paper topic	Analysis of the IFRS Interpretations Committee's comments on IASB proposals

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Introduction

1. At their joint meeting in September 2015, the IASB and the FASB discussed the FASB's tentative decisions on how to clarify the definition of a business and related application guidance.
2. In October 2015, the IASB discussed an analysis of the FASB's proposals on how to improve the application of the definition of a business and decided to propose changes to IFRS 3 *Business Combinations* that are the same as the amendments proposed by FASB.
3. During the October 2015 IASB meeting, some IASB members asked whether the proposed amendments would help solve the practical problems that had been raised to the IFRS Interpretations Committee ('the Interpretations Committee') about the definition of a business.
4. In November 2015, the Interpretations Committee discussed the proposed amendments to IFRS 3 and noted that the proposed amendments to IFRS 3 *Business Combinations* would help solve the practical problems that had been raised to the Interpretations Committee about the definition of a business. However, some Interpretations Committee members raised some comments/questions about the proposed amendments.

Objective

5. The objective of the discussion at this meeting is to decide upon whether we need to propose further amendments to IFRS 3. For this reason, in the following paragraphs, we report the main comments received from the Interpretations Committee members and provide our views and recommendations on each comment.

Interpretations Committee main comments

6. The Interpretations Committee noted that the proposed amendments to IFRS 3 would help address the existing uncertainties about the definition of a business.
7. We understand that many Interpretations Committee members believe that the proposals are a clear improvement to the existing guidance and that the outcomes of the proposals would be in line with predominant practice. However, some Interpretations Committee members expressed concerns about some of the proposed amendments.
8. The main comments received are the following:
   (a) some Interpretations Committee members questioned whether the assessment of whether substantially all of the fair value of the assets acquired is concentrated in a single asset (or group of similar assets) is needed, or workable;
   (b) some Interpretations Committee members asked the IASB to clarify whether there are circumstances in which the acquisition of an outsourcing agreement would represent acquisition of a substantive process;
   (c) one Interpretations Committee member asked for clarity over the impact of the changes on vertical integration (ie the acquisition of a supplier); and
   (d) some Interpretations Committee members asked the IASB to add examples for financial institutions and extractive activity entities.

Staff analysis

Is the assessment of whether substantially all the fair value is concentrated in a single asset needed or workable?

The proposed amendment

9. In October, the IASB decided that an acquired set of activities and assets (a set) is not considered a business if substantially all of the fair value of the gross assets acquired (including any acquired intangible asset that is not identifiable) is concentrated in a single identifiable asset or group of similar identifiable assets. If this threshold is met, the set of assets would not be a business and an entity does not need to consider further guidance to determine whether the set includes a substantive process.
10. This proposal requires an entity to compare the fair value of the single asset acquired (or group of similar assets) with the fair value of the gross assets acquired rather than with the total consideration paid or net assets.
11. The threshold could be met even if the fair value is concentrated in a group of similar identifiable assets (ie not only when the fair value is concentrated in a single asset). If an entity acquires, for example, ten similar buildings and other assets, the entity should compare the fair value of the ten buildings acquired with the fair value of the gross assets acquired and determine whether the threshold is met. However, the following should not be combined into a single asset or considered similar assets:

    (a) tangible and intangible assets;

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

    (c) financial and non-financial assets;

    (d) different major classes of financial assets (for example, cash, accounts receivable, and marketable securities); and

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

Concern raised

12. Some Interpretations Committee members observed that the existence of a process is what distinguishes a business from an asset (or a group of assets), because all asset acquisitions have inputs. They observed that the proposed guidance on substantive processes[1] should be sufficient in distinguishing a business from an asset. Consequently, they questioned whether the 'substantially all' threshold is needed.

Staff view

13. We think that, in most cases, the proposed guidance on substantive processes and the 'substantially all' threshold would lead to the same conclusion, because we expect that, usually, the fair value of a substantive process is more than insignificant. Consequently, we think that, in those cases, if the acquired set includes a substantive process, then the fair value of the gross assets acquired is not concentrated (ie the 'substantially all' threshold is not met).
14. However, we think that the proposed threshold is generally more straight-forward to apply than the proposed guidance on substantive processes, because, at least in some circumstances, it is less subjective. In other words, we think that the proposed threshold is a good practical approach to evaluate whether the acquired set of assets is a business and that it should be useful for asset-based industries.
15. Consequently, we think that the IASB should retain the proposed threshold and ask constituents whether they think that this practical approach is useful.

Application of the threshold to a property with an in-place lease

16. We also think that we need to clarify whether and how to apply the proposed threshold when a building is acquired with an in-place operating lease, because:

    (a) under US GAAP the acquirer recognises a tangible asset and an intangible asset for in-place leases as well as an asset or liability for the favourable or unfavourable aspect of the operating lease; while

    (b) paragraph B42 of IFRS 3 states that the acquirer does not recognise a separate asset or liability if the terms of the operating lease are either favourable or unfavourable when compared with market terms. As explained in paragraphs BC146-BC148 of IFRS 3, the IASB decided that

[1] The proposed guidance on substantive processes is summarised in paragraphs 23 – 25 of this paper.

the acquirer must follow the guidance in IAS 40 *Investment Property* for assets subject to operating leases in which the acquiree is the lessor. The IASB also observed that IAS 16 requires each part of an item of property, plant and equipment that has a cost that is significant in relation to the total cost of the item to be depreciated separately. Consequently, we think that if the building meets the definition of investment property, the acquirer would recognise that investment property and the fair value of the investment property would take into account rental income from current leases. If the building is within the scope of IAS 16 we think that the value of the in-place lease would be included in the cost of the building. Consequently, under IFRS a separate asset or liability for the in-place lease is not recognised.

17. This clarification is important, because under the proposed amendments it is not necessary to assess the other criteria (ie whether a substantive process exists) if the threshold is met, ie if the fair value is concentrated in a single asset. On the contrary, if the threshold is not met, the proposal requires an entity to assess whether a substantive process exists.

18. In our view, we have the following options:

(a) clarify that the in-place operating lease is considered a separate asset only for the purposes of the evaluation of the threshold (Option 1). This option requires estimating the value of the building and the value of the lease separately for the purpose of the assessment only. The accounting consequences of the assessment would be:

(i) If the set of assets is a business, the acquirer shall continue to apply paragraph B42 of IFRS 3, which states that the acquirer includes the lease in the measurement of the leased property and so the lease is not recognised separately.

(ii) If the set of assets is not a business and the building meets the definition of investment property, the acquirer shall continue to apply paragraph 40 of IAS 40, which states that when measuring the fair value of investment property an entity shall ensure that the fair value reflects, among other things, rental income from current leases.

(iii) If the set of assets is not a business and the building is within the scope of IAS 16, the value of the in-place lease would be included in the cost of the building and if the value of the lease is significant it should be depreciated separately.

Consequently, in all cases (i), (ii) and (iii), the value of the lease is included in the value of the property; or

(b) clarify that the building acquired and the in-place operating lease shall be considered a single asset for the evaluation of the threshold (Option 2). This means that:

(i) Example 1: if the acquired set of assets only includes: (a) a building, (b) in-place leases (that have a significant fair value) and (c) the seller's employees that perform ancillary processes (the fair value associated with the acquired workforce is insignificant); then the threshold is not met under US GAAP but it is met under IFRS. Under US GAAP, the lease is a separate asset with significant fair value associated with it and so the fair value of the assets acquired is not concentrated in the building. Under IFRS the value of the lease is included in the value of the property and so the fair value is concentrated in a single asset. Consequently the analysis under US GAAP would proceed to the next assessment, which is consideration of whether there is a substantive process acquired. In this example, only an ancillary process is acquired, and not a substantive process. Consequently under both IFRS and US GAAP the acquired set of assets is not a business.

(ii) Example 2: if the acquired set of assets includes: (a) a building, (b) in-place leases (that have a significant fair value) and (c) the seller's employees that perform a substantive process (the fair value associated with the acquired workforce is *greater than insignificant*); then under both IFRS and US GAAP the threshold is not met. Consequently the analysis under both IFRS and US GAAP would proceed to the next assessment, which is consideration of whether there is a substantive process acquired. In this example, the set is a business, because it includes an input and a substantive process.

(iii) Example 3: if the acquired set of assets includes: (a) a building, (b) in-place leases (that have a significant fair value) and (c) the seller's employees that perform a substantive process (the fair value associated with the acquired workforce is *insignificant*); then the threshold is again not met under US GAAP, but it is met under IFRS. In this case, under US GAAP, the subsequent assessment of whether there is a substantive process this time leads to the conclusion that the acquired set is a business; this is because the fair value is not concentrated in a single asset and the set includes an input (ie the building) and a substantive process. In contrast, under IFRS, the set is not a business, because under the proposal it is not necessary to assess the other criteria (ie whether a substantive process exists) if the threshold is met, ie if the fair value is concentrated in a single asset.

19. In our view, Option 2 would create a difference with US GAAP in the scenario described in Example 3. In Example 3, the fair value associated with an acquired workforce that performs a *substantive process* is *insignificant*. We think that this fact pattern is not common in practice, because we think that the fair value associated with a substantive process would usually be *more than insignificant*.
20. We also think that Option 1 would create additional costs for preparers, because they would be required to separately estimate the fair value of the in-place lease and the fair value of the building, only for the purposes of the evaluation of the threshold.
21. Consequently, we support Option 2 and we think that the IASB should clarify in the illustrative examples of the proposed amendments that a building acquired and an in-place operating lease shall be considered to be a single asset for the evaluation of the threshold.
22. We do not expect that the situation described in Example 3, in which a substantive process has an insignificant fair value, would be common in practice. Consequently we do not expect significant diversity in practice between IFRS and US GAAP as a result of this difference.

Are there circumstances in which the acquisition of an outsourcing agreement would represent acquisition of a substantive process?

The proposed amendment

23. In October, the IASB decided that to be considered a business, a transaction must include, at a minimum, an input and a substantive process that together contribute to the ability to create outputs. The IASB also decided to provide guidance to help determine whether a substantive process exists. The proposed guidance includes two different sets of criteria to consider, which depend on whether the acquired set of assets has outputs.
24. When acquired set of assets does not have outputs, in order to have a substantive process, the acquired set should include an organised workforce that has the necessary skills to perform an acquired process that, when applied to another acquired input, is critical to the ability to develop or convert that acquired input into outputs.
25. When the acquired set of assets has outputs, any of the following would indicate that the set includes a substantive process:

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

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

Concern raised

26. Some Interpretations Committee members observed that the proposed amendments do not provide sufficient guidance on whether and how inputs and processes that have been outsourced should be considered in the assessment of whether an acquired set of assets constitutes a business. They think that additional guidance may be needed to adequately address this issue.
27. One Interpretations Committee member also asked the IASB to clarify whether it is necessary for the acquirer to have taken over outsourcing agreements that have been entered by the seller or whether it is sufficient to enter into an outsourcing agreement with the seller or a third party during the acquisition.

Staff view

28. The proposed guidance on substantive process does not distinguish between inputs and processes of the seller and inputs and processes that have been outsourced by the seller. Indeed, the Proposed Accounting Standards Update *Clarifying the Definition of a Business*, issued by FASB in November 2015[2] includes the following paragraph:

> 805-10-55-5D For purposes of the analysis in paragraphs 805-10-55-5A through 55-5B, an organized workforce could consist of employees and/or certain contractual arrangements that take the place of employees (for example, a property or asset management contract). An entity should consider whether the service provided through a contractual arrangement performs an acquired process (or group of processes) that is critical to the ability to create outputs when applied to another acquired input or inputs or if the contractual arrangement is an acquired input.

29. In addition, one of the examples developed by FASB and discussed at the October IASB meeting specifies that the acquired outsourcing agreements may be considered as providing an organised workforce.
30. Consequently, we think that according to the proposed amendments this means that the acquirer would need to consider whether the outsourced workforce performs a substantive process and whether the entity controls the substantive process.
31. For example: Entity B is the owner of the hotel and has outsourced the management of the hotel to Entity C (ie the hotel is managed by employees of Entity C). Entity A acquires the hotel from Entity B and takes over the outsourcing agreements. We think that Entity A should assess whether the management of the hotel is a substantive process. We think that according to the proposed amendments the management of the hotel is a substantive process (because it is critical to the ability to create outputs) and so a business exists. However, in this case, we think that Entity A should also assess whether it has obtained control over the hotel business or whether the business is still controlled by Entity C. So, in our view, when a business is identified, but the

[2] The FASB Proposed Accounting Standards Update can be downloaded at this link http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176167640849&acceptedDisclaimer=true

operation of the business has been outsourced, the issue is whether control of that business rests with the acquirer, or with the outsourced operator. We think that this assessment will depend on the specific facts and circumstances and that providing guidance on who controls the business is outside of the scope of this project.

32. We think that the IASB should clarify in the proposed amendments to the application guidance of IFRS 3 (and not only in the illustrative examples) that the acquired outsourcing agreements may be considered as providing an organised workforce and that the acquirer should consider whether the acquired outsourcing agreements perform a substantive process (ie a process that is critical to the ability to create outputs).

Acquisition of a supplier

The proposed amendment

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

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

Concern raised

34. One Interpretations Committee member questioned whether the decision to narrow the definition of 'outputs' to focus on goods and services provided to customers will have an impact on a vertical integration (ie the acquisition of a supplier). The question has arisen because, if after the transaction all output is consumed by the acquirer, the supplier will not provide goods and services to customers and so it might not be considered a business under the proposals.

Staff view

35. We note that when the IASB discussed the proposal to amend the definition of 'output', it decided to retain the sentence 'capable of being conducted and managed for the purpose of providing a return' in the definition of a business. We think that after the transaction the acquired supplier would still be 'capable of' generating revenues (ie the supplier does not generate revenues only because all output is consumed by the acquirer), and so it could qualify as a business, if the other criteria are met. In addition, we note that we are not proposing to modify paragraph B11 of IFRS 3, which states that: 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.
36. We think that the IASB should include this explanation in the Basis for Conclusions of the proposed amendments to avoid any misunderstanding.

Additional examples

37. Some Interpretations Committee members asked the IASB to add two examples to illustrate how to apply the proposed guidance in the financial sector and in the extractive industries sector.
38. We agree with this proposal, because during the Post-implementation Review (PIR) of IFRS 3 we learnt that in these sectors it may be particularly difficult to determine whether the acquired set of assets is a business.
39. We include in Appendix A of this paper the draft examples.

Staff recommendations

40. On the basis of the analysis above, we recommend that the IASB should:

    (a) retain the 'substantially all' threshold and ask constituents whether they think that this practical expedient is useful;

    (b) clarify in the illustrative examples of the proposed amendments that a building acquired and an in-place operating lease shall be considered a single asset for the evaluation of the 'substantially all' threshold;

(c) clarify in the proposed amendments to the application guidance of IFRS 3 that the acquired outsourcing agreements may be considered to provide an organised workforce and that the acquirer should consider whether the acquired outsourcing agreements perform a substantive process;

(d) explain in the Basis for Conclusions of the proposed amendments that: when an entity acquires a supplier and after the transaction the supplier ceases generating revenues, because all output is consumed by the acquirer, the supplier would still be 'capable of' generating revenues, and so it might qualify as a business, if the other criteria are met; and

(e) add two illustrative examples on how to apply the proposed guidance in the financial sector and in the extractive industries sector.

Question for the IASB members
Do you agree with the staff recommendations described in paragraph 40?

Appendix A – Draft examples

Acquisition of Oil and Gas Operations[3]

A1. Company X is an oil- and gas-producing company that operates a large portfolio of producing properties. Company X owns 100 percent of a mineral interest in and is currently operating Property A, which is a producing property that is generating revenues. Company X enters into an agreement to sell Property A to Company Y, another oil- and gas-producing company. As part of the transaction, Company Y acquires the mineral interests, customer contracts, drilling equipment, a gathering system, and supply contracts. The set also includes operational processes related to extracting and transporting the oil and gas, which are in place and facilitated through the existing infrastructure. However, the set does not include Company X's employees, and Company Y plans to use its own employees in the operations of Property A.

A2. Company Y first considers whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. Company Y concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets because there is significant fair value in different groups of tangible assets (equipment and the gathering system) and intangible assets (mineral interests). Therefore, Company Y does not further assess whether the groups of tangible assets are groups of similar assets.

A3. Because there is a continuation of revenue, the set has outputs and Company Y evaluates the criteria in paragraph XX to determine whether it acquired both an input and a substantive process that together contribute to the ability to create outputs. The criteria in paragraph XX are not met because Company Y did not acquire an organized workforce and the operational processes would not be considered unique or scarce in the oil and gas industry. The criterion in paragraph XX is met because the operational processes associated with extracting and transporting the oil and gas that are being applied to acquired inputs, such as the mineral interest, contribute to

[3] This example is included in the FASB Proposed Accounting Standards Update *Clarifying the Definition of a Business*

the ability to continue producing outputs and replacing the process would result in a significant cost, effort, or delay in the ability to continue producing outputs. That is, because the operational processes are in place and will continue to be performed through and partially by the existing infrastructure, to replace those processes would require the operation to shut down and replace the equipment and infrastructure, which would be costly and delay the production of outputs. Company Y concludes that the set is a business because the set includes both inputs and a substantive process that together contribute to the ability to create outputs.

Acquisition of mortgage loan portfolio[4]

A4. Bank A acquires a mortgage loan portfolio from Bank B. Bank A also takes over the employees of Bank B that manage the credit risk of the portfolio and the relationships with the borrowers (such as brokers, vendors and risk managers).

A5. Bank A first considers whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. The identifiable assets in the set include financial assets and customer relationships. In addition, Bank A concludes that there is fair value associated with the acquired workforce. Consequently, Bank A concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets.

A6. The set has outputs through the continuation of interest income arising from the loan portfolio. Consequently, Bank A must consider the criteria in paragraph XX to determine whether the set includes both an input and a substantive process that together contribute to the ability to create outputs.

A7. Bank A concludes that the set includes an organized workforce that performs processes critical to the ability to continue producing outputs when applied to the acquired inputs (ie Bank A concludes that customer relationships management and credit risk management are critical to the creation of outputs). Bank A concludes

[4] This example has been developed by IASB staff. It is not included in the FASB Proposed Accounting Standards Update *Clarifying the Definition of a Business.*

that the set is a business, because the set includes both inputs and a substantive process that together contribute to the ability to create outputs.