

EXPOSURE DRAFT 2016/01

DEFINITION OF A BUSINESS AND ACCOUNTING FOR PREVIOUSLY HELD INTERESTS

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2016/07



Summary

The International Accounting Standards Board (IASB) has published Exposure Draft ED/2016/01 *Definition of a Business and Accounting for Previously Held Interests* (the ED).

In this ED the IASB proposes to amend IFRS 3 *Business Combinations* and IFRS 11 *Joint Arrangements*. It is proposed to clarify:

- a) the definition of a business; and
- b) the accounting for previously held interests when an entity obtains control of a business that is a joint operation and when it obtains joint control of a business that is a joint operation.

The IASB invites comments on any aspects of this Exposure Draft, particularly on the following topics:

- the proposal that, if substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, then the set of activities and assets is not a business;
- differences between the IASB's and FASB's proposals of amendments and differences in practice that could emerge from the different wording;
- acquisitions of interests in business that are joint operations; and
- the proposal for prospective application (with early application permitted) of the amendments to the definition of a business and the accounting for previously held interests.

The comment deadline for ED/2016/1 *Definition of a Business and Accounting for Previously Held Interests* is 31 October 2016.

STATUS

Exposure Draft

EFFECTIVE DATE

To be confirmed

ACCOUNTING IMPACT

Might be relevant

Background

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

The Post-Implementation Review (PIR) of IFRS 3 *Business Combinations* carried out by the IASB identified difficulties in applying the definition of a business.

IFRS 3 resulted from a joint project between the Board and the FASB, and the requirements in IFRS and USGAAP regarding business combinations are substantially converged. The proposed amendments to IFRS 3 and the Proposed Accounting Standards Update *Clarifying the Definition of a Business* (issued by the FASB in November 2015) are based on substantially converged tentative conclusions.

The IASB was also informed that there is diversity in practice in accounting for previously held interests in the assets and liabilities of a joint operation in two types of transactions: those in which an entity obtains control of a business that is a joint operation and those in which it obtains joint control of a business that is a joint operation.

The proposed amendments to IFRS 3 *Business Combinations* and IFRS 11 *Joint Arrangements* are intended to clarify the definition of a business and the accounting for these types of transactions involving joint operations.

IFRS 3 Business Combinations

Accounting for previously held interests

The IASB proposes to clarify that, when an entity obtains control of a business that is a joint operation, the entity applies the requirements for a business combination achieved in stages, including remeasuring previously held interests in the assets and liabilities of the joint operation to fair value.

It is proposed to apply the amendment to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after the effective date of the amendment, with early application permitted.

Definition of a business

The Board proposes:

- a) 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 have the ability to contribute to the creation of outputs;
- b) to remove 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;
- c) to revise the definition of outputs to focus on goods and services provided to customers and to remove the reference to the ability to reduce costs;
- d) to consider a set of activities and assets not to be a business if, at the transaction date, substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets;
- e) to add guidance to help determine whether a substantive process has been acquired;
- f) to add examples to help with the interpretation of what is considered a business; and

- g) that an entity would not be required to apply the proposed amendments to transactions that occur before the effective date of the amendments.

Minimum requirements to be a business

The Board decided that to be considered a business, an acquisition must include, at a minimum, an input and a substantive process that together contribute to the ability to create outputs, i.e. it is not necessary for all of the inputs and processes needed to create outputs to be acquired for the set of activities and assets to be a business.

Market participant capable of replacing missing elements

It was noted that, currently, some sets of activities and assets may be considered to be a business for market participants who could integrate the set of activities and assets into their existing processes. However, the same set of activities and assets may not be considered a business from the perspective of other market participants.

It is proposed that the ability of some market participants to integrate an acquired set of activities and assets should not be considered in determining whether the acquisition is a business combination. The Board believes that the assessment should be based on what has been acquired, rather than on how a market participant could potentially integrate the acquired activities and assets.

The proposed amendments would provide new tests to assess whether the minimum requirements for a set of assets and activities to be a business are met.

Definition of output

It is proposed to narrow the definition of outputs to focus on goods and services provided to customers.

The proposed definition excludes:

- a) returns in the form of lower costs; and
- b) other economic benefits provided directly to investors or other owners, members or participants.

This is consistent with how outputs are discussed in IFRS 15 *Revenue from Contracts with Customers*. However, the Board decided to include in the definition other types of outputs due to the fact that not all entities have revenues that are within the scope of IFRS 15.

The proposed changes to the definition of outputs would narrow the types of outputs to be considered.

Fair value of the assets acquired is concentrated in a single asset

It is proposed to provide a screening test that will make it easier in some cases to determine, without further analysis, that a set of activities and assets acquired does not constitute a business.

It is proposed that further assessment of whether a set of activities and assets is a business would not be appropriate 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 Board decided that it was not necessary to provide further guidance for application of the term 'substantially all'.

It is important to note that the proposed screening test refers to the fair value of the gross assets acquired and not to the fair value of the total consideration paid or net assets. This is important, for example, when the net assets acquired include a significant component of debt or liabilities.

Evaluating whether an acquired process is substantive

Rather than trying to develop a single definition of what a substantive process is, it is proposed to add guidance to determine whether a process that has been acquired is substantive.

The clarifications propose two similar but distinct tests of acquired processes depending on whether the acquired set of activities and assets has outputs.

- a) The acquired set of activities and assets does not have outputs

In these cases, 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 (or are) intended to be developed into outputs. The Board believes that the intellectual capacity of an organised workforce, i.e. their capacity to perform a process even if the process is not documented, is a process.

- b) The acquired set of activities and assets has outputs

When the acquired set of activities and assets has outputs, there is more evidence that the acquired set is a business. Because inputs are already being converted into outputs, it is not important to consider the type of inputs acquired.

The IASB considers that it is only in some limited circumstances that an organised workforce is not required in order to conclude that the set of activities and assets is a business. These circumstances are:

- a) the set has outputs; and
- b) the acquired set includes a process (or a group of processes) that is unique or scarce, or is difficult to replace.

Transition

It is proposed that an entity would be required to apply the proposed amendments to IFRS 3 to any business combination for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after the effective date of the amendments, with earlier application permitted.

IFRS 11 Joint Arrangements

Accounting for previously held interests

The IFRS Interpretations Committee noted that there is diversity in practice in accounting for previously held interests in the assets and liabilities of a joint operation when an investor obtains joint control of a business that is a joint operation. The issue is whether an entity applies the principles on accounting for a business combination achieved in stages to those previously held interests when the investors obtains joint control.

The transaction subject to analysis is analogous to a transaction that results in an investment in an associate becoming an investment in a joint venture and vice versa. As stated in IAS 28 *Investment in Associates and Joint Ventures*, an investor does not apply the principles on accounting for a business combination achieved in stages to those previously held interests.

The Board proposes that, when an investor obtains joint control of a business that is a joint operation, the entity should not remeasure previously held interests in the assets and liabilities of the joint operation.

Transition

The Board proposes that an entity apply the proposed amendment to IFRS 11 to transactions for which joint control is obtained on or after the beginning of the first annual reporting period beginning on or after the effective date of the amendment, with earlier application permitted.



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