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## **Definition of a business**

### **Issues Paper**

#### **Objective**

- 1 The objective of this paper is to consider the forthcoming amendments to the definition of a business under IFRS 3 *Business Combinations* (the forthcoming amendments) and ask EFRAG TEG for views on these amendments including preliminary direction to develop EFRAG's draft endorsement advice.
- 2 The IASB's current work plan informs that the forthcoming amendments will be published in June 2018.

#### **Structure of this paper**

- 3 In this paper, the EFRAG Secretariat summarises the expected content of the forthcoming amendments. The analysis is based on the IASB decisions taken at its meetings in April, June and October 2017.
- 4 This paper is structured as follows:
  - (a) Background.
  - (b) The forthcoming amendments.
  - (c) The screening test.
  - (d) Other clarifications and changes.
  - (e) Transition.
  - (f) Developing the EFRAG draft endorsement advice.
  - (g) Appendix 1 – differences between the forthcoming amendments and FASB 2017 Amendments.

#### **Background**

##### *The IASB's Exposure Draft*

- 5 On 28 June 2016, the IASB issued the Exposure Draft ED/2016/1 *Definition of a Business and Accounting for Previously Held Interests* (the ED).
- 6 The ED responded to concerns raised during the post-implementation review of IFRS 3 and proposed to clarify the application of the definition of a business with the objective of assisting entities to determine whether a transaction should be accounted for as a purchase of assets or as a business combination.
- 7 The ED also proposed guidance on the accounting for previously held interests of a joint operation. The IASB decided to issue the amendments on previously held interests as part of the IASB's *Annual Improvements to IFRS Standards 2015-2017 Cycle* published in December 2017.

- 8 The main proposal in the ED was the screening test<sup>1</sup> which required an entity 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.
- 9 In addition, the ED also provided the following clarifications/amendments to help assess whether a transaction is a business:
- (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) Revised the definition of outputs to focus on goods and services provided to customers and remove the reference to the ability to reduce costs.
  - (c) Removed 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.
  - (d) Added guidance to help determine whether a substantive process has been acquired.
  - (e) Added examples to illustrate the application of the proposed guidance.

*EFRAG's comment letter on the ED*

- 10 EFRAG issued its comment letter on the ED in November 2016. (Provided as **agenda paper 07.02** for background purposes).
- 11 EFRAG welcomed the IASB's objective of providing clearer application guidance to help determine when a set of assets and activities constitutes a business, and address concerns that the current definition is too broad and lacked guidance on what should not be considered a business. However, EFRAG raised the following points:
- (a) EFRAG acknowledged the difficulties in drafting a screening test that is easy to apply, addresses concerns reported by preparers and reaches the appropriate conclusion in every possible set of facts and circumstances. However, EFRAG was concerned that, as currently drafted, the screening test may, in some instances, result in inappropriate conclusions.
  - (b) EFRAG agreed with having two different sets of criteria to assess whether an acquired process is substantive, depending on whether the set of activities and assets has outputs. However, EFRAG expressed some concerns about the presence of goodwill as an indicator, the guidance on acquired contracts and asked for clarification on the role of an organised workforce.
  - (c) EFRAG recommended that the examples focus more on the areas of the guidance that require significant judgement.
  - (d) EFRAG encouraged the IASB and the FASB to reach converged solutions on their respective proposed amendments.
  - (e) Finally, EFRAG observed that the tension arising from the distinction between business combinations and asset acquisitions originates to a significant degree from differences in the accounting, and encouraged the IASB to consider in due course whether or not these accounting differences are justified by differences in the economic substance.

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<sup>1</sup> In more recent discussions, the IASB refers to this assessment as a 'concentration test' rather than a 'screening test'. This paper continues to use the term 'screening test'.

*The FASB 2017 Amendments on the definition of a business*

- 12 In November 2015, the US Financial Accounting Standards Board (FASB) published the Proposed *Accounting Standards Update Clarifying the Definition of a Business*. The final Update was published in January 2017 (the FASB Amendments).
- 13 The FASB's objective was to narrow the application of the definition of a business so that practice under US GAAP and IFRS would be more closely aligned. Although the definition was identical, it was not interpreted or applied consistently in practice between jurisdictions that apply IFRS and those that apply US GAAP.
- 14 The main difference between the FASB Amendments and the IASB forthcoming amendments is the screening test. The FASB decided to maintain its original proposal and make the screening test mandatory. A number of other subtle differences exist, which could result in different conclusions. Appendix 1 lists the main differences between the two sets of amendments.

**The forthcoming amendments**

- 15 The IASB received 80 comment letters on the ED. The IASB discussed the proposals at its meetings in April, June and October 2017, and affirmed most of the proposals, except for the screening test, which instead of being a mandatory initial assessment, will be an optional test.
- 16 The IASB also agreed to clarify a number of aspects of the proposals when finalising the amendments. Although the examples are largely the same as in the ED, a number of clarifications have been made.
- 17 The forthcoming amendments should apply for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning or after 1 January 2020, with earlier application permitted.
- 18 EFRAG TEG discussed the IASB tentative decisions on the ED at the EFRAG TEG/CFSS meeting in September 2017. These are discussed in more detail in the paragraphs below.

**A. THE OPTIONAL SCREENING TEST**

- 19 The screening test will apply as follows:
  - (a) If the test is met, the set of activities and assets may be considered not to be a business and no further assessment is needed. The test will be met if there is a concentration of fair value of the gross assets acquired in a single asset or group of similar assets.
  - (b) If the test is not met, or if the entity elects not to apply it, the entity shall perform a more detailed assessment to determine whether an acquired set of activities and assets is a business or not.
- 20 The EFRAG Secretariat understand that the test is not determinative as an entity will not be prohibited from performing the detailed assessment, even if the screening leads to the conclusion that the transaction is an asset acquisition. The IASB decided that a prohibition from carrying the detailed assessment was not necessary, because if the entity intended to disregard the outcome of the test, it would not have applied it.
- 21 Therefore, in our view, the screening test is a rebuttable presumption in the sense that if an entity chooses to do the test, and the test is met, it can rebut that outcome by applying the detailed assessment.
- 22 The gross assets considered in the screening test will exclude:
  - (a) Cash and cash equivalents acquired;

- (b) Goodwill resulting from the effects of deferred tax liabilities; and
- (c) Deferred tax assets

*EFRAG position in its comment letter on the screening test and feedback from other respondents*

- 23 In its comment letter on the ED, EFRAG was concerned that, as currently drafted, the screening test may, in some instances, result in inappropriate conclusions. That is, the screening test might lead to a conclusion that is inconsistent with what would be concluded through the assessment of whether an acquired process is substantive.
- 24 EFRAG noted that the screening test should be retained as a mandatory assessment only if its relative simplicity can be maintained while avoiding inappropriate outcomes.
- 25 If EFRAG's suggestion is not accepted, EFRAG recommended that the IASB consider ways to take pressure off the test – for example by changing it into either an indicator or a rebuttable presumption. EFRAG also suggested that the screening test should not be required in cases where it is clearly evident that the acquired set meets the general definition of a business. Many other respondents expressed similar concerns.
- 26 EFRAG also noted that if the IASB retained the screening test, it should clarify what should be included in 'gross assets' including the effects of deferred taxation, when assets are considered 'similar', and how to measure the fair value of gross assets. Various other respondents made a similar suggestion.

*IASB rationale to support the forthcoming amendment*

- 27 To address the concerns and suggestion in paragraphs 23 and 24, the IASB decided to make the screening test optional on a transaction-by-transaction basis, as well as introduce a rebuttable presumption when the test is applied and is met.
- 28 This would permit an entity to bypass the test and assess directly whether a substantive process has been acquired, if this assessment would be more efficient or result in a conclusion that better reflects the economics of a particular transaction. In other words, an entity can rebut the outcome of the test when it is met, and apply the detailed assessment.
- 29 The IASB decided not to prohibit an entity from carrying out the detailed assessment if the screening test leads to the conclusion that the acquired set is not considered a business. In the view of the IASB, this prohibition was unnecessary, because if an entity intended to disregard the outcome of the test, it would not have applied it.
- 30 The IASB acknowledged that if the screening test is made optional, there would be accounting consequences in cases of a false positive – that is, the risk of the screening test wrongly identifying a transaction as an asset acquisition, and this outcome is not rebutted. A false positive will deprive users of financial statements of useful information that is provided under IFRS 3 for a business combination, which is significant different to the accounting for an asset.<sup>2</sup>
- 31 However, the IASB assessed the risk of a false positive as being insignificant, as substantially all the fair value of the gross assets acquired is concentrated in a single asset or group of similar assets, the likelihood of the acquired set containing a substantive process (with a substantive fair value) is small. Accordingly, it assessed

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<sup>2</sup> Other than the recognition of goodwill, other significant differences between accounting for an asset acquisition and a business combination include deferred taxes, contingent consideration, acquisition-related costs, and gains on bargain purchases.

that the optional test was worthwhile in light of the cost-saving benefits that it is expected to bring.

- 32 The IASB rejected re-characterising the screening test into a mandatory indicator or solely as a rebuttable presumption, without an option. This is because both these suggestions would require an entity to carry out a full assessment to see whether there is contrary evidence that would rebut the asset presumption, even if the screening test concluded that the transaction is an asset acquisition. The IASB believed that this extra step would defeat the purpose of having the test, which is intended as a simplification and reduce the cost and complexity of applying the business definition guidance.

*The FASB decision*

- 33 The FASB confirmed that the screening test should be mandatory and provided some clarifications. The FASB noted that stakeholders' concerns about too many transactions meeting the threshold in the screening test will be mitigated by other decisions, such as the narrowing of the population of what could be considered similar assets.
- 34 The FASB considered whether the screening test ought to be a rebuttable presumption or an indicator. However, the FASB came to the conclusion that it should choose between a mandatory test and no test at all. The reaction at the FASB was that if it was a rebuttable presumption then it would increase the cost.

*Recent EFRAG TEG discussions*

- 35 EFRAG TEG discussed the responses to the proposed screening test and the IASB tentative decision for an optional screening test at the EFRAG TEG/CFSS meetings in February and September 2017.
- 36 During the discussion in February, EFRAG TEG members acknowledged the difficulty of retaining the simplicity of the proposed test while totally avoiding outcomes that differ from the application of the rest of the proposed guidance. Some members also noted that changing the form of the screening test into either an indicator or a rebuttable presumption could also lead to complications, and questioned whether the screening test should be retained. The majority of members expressed support to retain the test but in a non-determinative form.
- 37 During the discussion in September, EFRAG TEG members expressed mixed views on the test being optional as this could lead to opportunistic decisions by preparers.
- 38 However, members that preferred the IASB original proposal, continued to express concerns with the extent of the false positives in case of a mandatory test. The extent of this issue was not really known so it was difficult to assess it.
- 39 Some EFRAG TEG members did not oppose the optional test as it provided a simplification, and in addition they thought it was more of a rebuttable presumption which was in line with EFRAG's suggestion in its comment letter of turning the screening test into a rebuttable presumption. These members also noted that it was preferable to have a principle than a rule in this situation, so they accepted an optional test.
- 40 Some members regretted the absence of convergence with the FASB model (in which the screening test is mandatory).

*Previous ASAF discussions*

- 41 Similar to EFRAG TEG/CFSS members, ASAF members expressed mixed views on the optional screening test. Those against, said they preferred to change the test to an indicator or a rebuttable presumption, without the option. Those in favour of an optional test, agreed that an entity should be permitted to choose whether to

perform the test and then should be permitted to choose whether to accept or to rebut the outcome of the test.

- 42 ASAF members generally encouraged the IASB to remain converged with the FASB on their respective amendments.

*CMAC discussion*

- 43 In March 2017, the IASB Staff discussed the screening test with CMAC members. Similar to other constituents, CMAC members observed that in some cases the screening test may not give the right result.

*EFRAG Secretariat analysis and preliminary views*

- 44 The EFRAG secretariat notes that the screening test includes a rebuttable presumption as explained in paragraph 20, which is in line (or partly in line) with EFRAG's recommendation in its comment letter to the ED. In other words, an entity can rebut the outcome when the test is met.

- 45 An optional screening test optional (on a transaction-by-transaction basis) has advantages and disadvantages.

*Advantages*

- 46 An optional screening test has the following advantages:
- (a) It reduces pressure on the detailed design of the test. Several respondents, including EFRAG, raised a number of comments and questions about the design of the test and argued that the test should be maintained only if it could be kept simple while avoiding inappropriate outcomes.
  - (b) It does not force entities to use the screening test in cases where they could reach the same answer more efficiently, and at less cost without using it.
  - (c) It does not force entities to identify a transaction as an asset purchase if the entity has clearly acquired a business but the fair value of the assets acquired (including 'core' goodwill) is concentrated in one asset (or in a group of similar assets).
- 47 The screening test should reduce costs for preparers, as it brings a simplified and practical way to determine when a transaction is not a business and reduces the amount of work needed to assess certain transactions.
- 48 With respect to convergence, the EFRAG Secretariat note that the EFRAG view in the past has been that if it is necessary to choose between a good standard and convergence, we should choose the good standard.

*Disadvantages*

- 49 The main disadvantage is comparability in case of a false positive and the entity chooses to accept the outcome (instead of rebutting it by moving to the full assessment). A false positive would occur when an entity selects the screening test to account for an asset acquisition when the transaction is in fact a business under the detailed assessment.
- 50 There is a question about the extent of false positives. This potential could lead to structuring opportunities and reduce comparability of information for users of financial statements, if an entity chooses to accept the outcome of the test in cases even though it is a false positive.
- 51 As noted in paragraph 31, the IASB believes that the risk of a false positive is relatively low. At this stage, we do not have evidence to support or explain this conclusion. In particular, we do not have evidence to confirm that in cases where substantially all the fair value of the gross assets acquired is concentrated in a single

asset or group of similar assets, the likelihood of the acquired set containing a substantive process (with a substantive fair value) is small.

- 52 Overall, if the number of cases of a false positive are insignificant, the concerns about comparability as well as relevant of information would be reduced and one could suggest that benefits to preparers would outweigh any loss of comparability and information to users.

**Questions for EFRAG TEG members**

- 53 What are your views on the screening test, and do you agree that it is in line with EFRAG's suggestion to turn the screening test into a rebuttable presumption?
- 54 Do you agree with the IASB's conclusion in paragraph 31 that the risk of a false positive is low? If you disagree, please provide evidence to support your answer and examples of false positive outcomes.

**B. OTHER CLARIFICATIONS AND AMENDMENTS**

- 55 EFRAG TEG has not discussed in detail the other forthcoming clarifications and amendments to the guidance in IFRS 3 to assess whether a set is a business, since the ED stage.
- 56 These clarifications aim to help preparers assess whether a transaction is a business, and enhance the benefits to users of financial statements by having a more understandable decision-making framework that is applied consistency.

***Minimum requirements to be a business and definition of output***

- 57 As per the ED, the forthcoming amendments will state that in order 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 significantly to the ability to create outputs.
- 58 The definition of 'output' will be amended by removing the reference to the ability to reduce costs, and clarifying that 'other revenues' means other income arising from contracts that are within the entity's ordinary activities but are outside the scope of IFRS 15 *Revenue from Contracts with Customers*.
- 59 The guidance will also clarify that if an acquired set of assets generated revenues before the acquisition, but is integrated by the acquirer and no longer generates revenues after the acquisition, that set of assets is regarded as creating outputs.

***EFRAG position in its comment letter on the ED***

- 60 EFRAG agreed with the proposal, because without those minimum requirements, the definition of a business would be so broad as to potentially include many transactions that economically are more in the nature of asset acquisitions.
- 61 EFRAG also supported the proposed change to the definition of outputs; but asked the IASB to clarify what was intended to be included in "other revenues", in order to ensure consistent application. The forthcoming amendments provide this clarification.

***EFRAG Secretariat observations***

- 62 The forthcoming amendments are in line with the ED proposals which EFRAG supported.
- 63 The EFRAG Secretariat notes that the FASB Amendments state that a set has outputs if there is a continuation of revenue *before and after the transaction*, which is different to the forthcoming amendments.

**Guidance on whether an acquired process is substantive**

- 64 As per the ED proposal, assessing whether an acquired process is substantive will depend on whether an acquired set of activities and assets does not have outputs or has outputs.
- (a) **If a set does not have outputs**, an acquired process (or processes) is considered *substantive* only if:
    - (i) It is critical to the ability to develop or convert an acquired input or inputs into outputs; and
    - (ii) The inputs acquired include both an organised workforce (with the necessary skills, knowledge, or experience to perform that process) and other inputs that the workforce could develop and convert into outputs. Examples of such inputs include intellectual property, and specific rights that enable creating outputs.
  - (b) **If a set has outputs**, an acquired process (or processes) is considered *substantive* if, when applied to an acquired input or inputs, it:
    - (i) Is critical to the ability to continue to create outputs, and the inputs acquired include an organised workforce (with the necessary skills etc.);  
**or**
    - (ii) Significantly contributes to the ability to continue creating outputs and it is unique or scarce or cannot be replaced with significant cost or effort or delay in creating outputs.
- 65 The forthcoming amendments will confirm that an outsourced workforce may perform a substantive process even if the acquired set of assets has no output, and specify that difficulties in replacing an acquired workforce may indicate that the workforce performs a substantive process.

*EFRAG position in its comment letter on the ED*

- 66 In its comment letter, EFRAG generally agreed with having two different sets of criteria depending on the existence of outputs.
- 67 EFRAG recommended to provide additional guidance to help entities to assess whether an acquired contract gives access to an organised workforce.

*EFRAG Secretariat observations*

- 68 The EFRAG Secretariat expects the wording of the forthcoming amendments to be clearer and explain whether an acquired contract can give access to an organised workforce.
- 69 The EFRAG Secretariat observes that 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*. The IASB forthcoming amendments considers that an acquired contract (instead of actual employees) could be a substantive process.

**Goodwill**

- 70 The forthcoming amendment will not to include the statement, proposed in the ED, that the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive. The IASB concluded that such a reference was not necessary and could create confusion.
- 71 The FASB on the other hand maintained this statement in its Amendments on the basis that it could be helpful to preparers to assess when a process with a workforce is substantive.

*EFRAG position in its comment letter on the ED*

- 72 In its comment letter, EFRAG agreed that the presence of more than an insignificant amount of goodwill may indicate that an acquired process is substantive.
- 73 However, EFRAG was concerned 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. EFRAG recommended to move the goodwill indicator to the Basis for Conclusions.

*EFRAG Secretariat observations*

- 74 The forthcoming amendment will address EFRAG's concern in paragraph 73.
- 75 The forthcoming amendment is not consistent with the FASB Amendments because paragraph 805-10-55-9 of the FASB Amendments states that *'When evaluating whether a set meets the criteria in paragraphs 805-10-55-5D through 55-5E, the presence of more than an insignificant amount of goodwill may be an indicator that the acquired process is substantive and, therefore, the acquired set is a business. However, a business need not have goodwill'*. However, in our view this difference should not cause significant divergence.

**Questions for EFRAG TEG members**

- 76 Do you agree with the other clarifications and changes to the definition of a business discussed above in:
- (a) Paragraphs 57 - 59;
  - (b) Paragraphs 64 - 65;
  - (c) Paragraph 70.
- 77 If you do not agree, please provide your reasoning.

**C. Transition**

- 78 The forthcoming amendments should apply for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning or after 1 January 2020, with earlier application permitted.

**Questions for EFRAG TEG members**

- 79 Do you agree with the transition requirements in paragraph 78?
- 80 At this stage, do you have any other comments on the forthcoming amendments?

**D. Developing the EFRAG draft endorsement advice**

- 81 The EFRAG Secretariat are of the view that the most significant change to the definition of a business is the introduction of the screening test.
- 82 The remaining forthcoming amendments aim at improving the existing guidance in IFRS 3 and help preparers to assess whether an acquired set is a business or not, and, are in our view straightforward and not controversial. They do not include any measurement requirements that could give rise to significant concerns about relevance, reliability or understandability or raise any new concerns.
- 83 Accordingly, the EFRAG Secretariat proposes to develop the EFRAG draft endorsement advice by focusing on the assessment of the screening test, and assessing the other clarifications and amendments as a collective package.

**Question for EFRAG TEG members**

- 84 Do you agree with the EFRAG Secretariat proposed strategy to develop the EFRAG draft endorsement advice as described in paragraphs 81 - 83? If not, what alternatives do you suggest?

## **Appendix 1 – Differences between the amendments to IFRS 3 and the FASB 2017 Amendments on the definition of a business**

- 1 The main differences between the IASB forthcoming amendments and the FASB 2017 Amendments (the FASB Amendments) on determining whether a set of activities and assets contains a business are:
  - (a) The IASB screening test described is optional. The corresponding test in the FASB Amendments is mandatory. However, the guidance on how to determine concentration of fair value is broadly the same.
  - (b) The IASB concluded that a process performed by an outsourced workforce may be substantive even if the acquired set of activities and assets has no output. In some cases, that may lead to a conclusion that a business was acquired. In contrast, the FASB concluded that when outputs are not present, a business was acquired only if the acquired set includes an organised workforce made up of employees.
  - (c) The IASB concluded that if an acquired set of activities and assets generated revenues before the acquisition, but is integrated by the acquirer and no longer generates revenues after the acquisition, that set of activities and assets is considered to be creating outputs. In contrast, according to the FASB Amendments, a set has outputs only if revenue continues after the transaction; if that condition is not met, a business is identified only if the narrower criteria for sets with no outputs are met, including the requirement for an organised workforce made up of employees.
  - (d) The IASB clarified that difficulties in replacing an acquired workforce may indicate that the acquired workforce performs a process that is critical to the ability to create outputs. The FASB Amendments do not include this clarification.
  - (e) The FASB Amendments include a statement that the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive. The IASB decided not include this statement.
  - (f) The IASB clarified that the narrowed definition of outputs includes other income arising within the entity's ordinary activities from contracts outside the scope of IFRS 15 *Revenue from Contracts with Customers*. The FASB made a similar clarification only in its Basis for Conclusions.
  - (g) The IASB aligned the definition of a business with the revised definition of outputs. The FASB did not align the two definitions, but its definition of a business refers explicitly to supporting guidance, including guidance on outputs. Accordingly, the two sets of guidance should have similar outcomes in relation to the definition of outputs.