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Mr Jean-Paul GAUZES
Chairman – EFRAG Board
35 square de Meeûs
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Belgium

ED 2016/1 Definition of a Business and Accounting for Previously Held Interests

Dear Mr Gauzes, Cher Jean-Paul,

I am writing on behalf of the Autorité des Normes Comptables (ANC) to express our views on the above-mentioned Exposure Draft issued in June 2016 *"Definition of a Business and Accounting for Previously Held Interests"*. This letter sets out the more critical comments raised by interested stakeholders involved in ANC's due process. Our Board has reviewed and approved this letter on October 14th 2016. The detailed responses to the IASB's and EFRAG's questions are included in the Appendix attached to ANC's comment letter.

As a preliminary remark, ANC is fully supportive of the IASB's efforts to clarify the definition of a business in IFRS 3 in order to enhance consistency between preparers, as long as this clarification meets the objective of distinguishing better and properly business combinations from assets acquisitions.

Despite the efforts undertaken, ANC believes that the implementation of the methodology aiming at clearly distinguishing assets and businesses remains somewhat inexplicit, notably as regards the proposed approach to identify a business. The points of attention raised by ANC are as follows:

- First of all, ANC considers that the intelligibility of the proposed amendment should be enhanced, in particular in the standard itself (clarifications provided in the basis for conclusions and examples should be incorporated). In addition, presenting a global diagram evidencing each step of the proposed approach could help clarifying the process.
- Another key comment refers to the fair value concentration test, which is in our view a rule-based approach rather than a principle-based approach. Therefore, ANC considers more appropriate to turn the test into a rebuttable presumption instead of proposing a binary and binding conclusion. The purpose of our proposal is to ensure that, based on judgment, all types of transactions are adequately accounted for without having to cope with a rule defining a stringent dividing line.
- ANC believes that the way an organised workforce transferred is analysed should be specified in the standard. Depending on the nature of the activity transferred, the relevance of the

workforce criterion is highly variable, and the standard should provide guidance on how to make judgement in this respect. In ANC's views it means that even though the existence of a workforce is in many instances an indicator, it should not be given an excessively predominant status.

Identifying a substantive process remains also difficult as this concept cannot be easily and precisely described.

Finally, the standard should clearly state that all other contracts, whether part of the acquisition or transferred concurrently with the acquisition, need to be considered when determining if a transaction qualifies as a business or not.

- The existence of goodwill is presented in the draft amendment as an indicator of a business but the link with the proposed methodology is not clear. When applying the decision tree to identify a substantive process, there is no room for assessing indicators such as the existence of goodwill. ANC questions the need to maintain this indicator, as the standard does not clearly state where and when goodwill shall be taken into consideration in the analysis.
- In addition, examples (that are not part of the standard) may in some instances be misleading or blur the understanding of the amendment. In this respect, ANC's stakeholders have underlined the following comments:
  - Examples focus on a limited number of activities / sectors. ANC believes that the proposed amendment, as drafted, does not fit all activities. Some businesses may face difficulties when applying this amendment and the current practice will probably change. In this regard, impacts should be anticipated and assessed in order to identify if the amendment proposes an economically and conceptually appropriate answer.
  - Some examples lead to counter-intuitive conclusions. In addition, facts patterns and rationales for the conclusion are often insufficiently detailed.

Concerning the second amendment of this Exposure Draft on *"previously held interests in joint operations"*, ANC supports the IASB's proposal aiming at clarifying the accounting treatment to apply. ANC also supports the transition provisions of this Exposure Draft.

As regards US GAAP convergence, ANC believes that, from inception to the publication of the standard, the IASB and FASB should both do their best efforts to work at the same pace. Such an approach would permit taking into consideration all stakeholders' positions when drafting the amendments. In the same spirit, ANC considers desirable that IASB discuss the FASB's on-going two additional phases of the project in order to determine if these issues are of interest in an IFRS environment and should be added to the IASB's work program.

Please do not hesitate to contact us should you want to discuss any aspect of our comment letter.

Yours sincerely, Bien amicalement.

Patrick de Cambourg

Patrick de CAMBOURG

Appendix

IASB - Question 1 – The Board is proposing to amend IFRS 3 to clarify the guidance on the definition of a business (see § B7-B12C and BC5-BC31). Do you agree with these proposed amendments to IFRS 3?

In particular, do you agree with the Board's conclusion that if substantially all the fair value of the gross assets acquired (i.e. the identifiable assets and non-identifiable assets) is concentrated in a single identifiable asset or group of similar identifiable assets, then the set of activities and assets is not a business (see § B11A-B11C)?

Why or why not? If not, what alternative would you propose, if any, and why?

EFRAG – Do you consider that the proposed illustrative examples are sufficient to illustrate how the proposed guidance on what is considered a business should be applied? If not, which areas of the proposed guidance should be clarified further in the illustrative examples?

ANC is positive about the IASB's efforts to clarify the definition of a business in order to determine if a transaction is a business combination or not. ANC also acknowledges that the IASB aims at proposing a pragmatic approach in the IFRS 3 amendments. Hence, this approach is expected to result in an increased number of assets as well as more converged interpretations with US GAAP.

However, ANC and its stakeholders consider that in some specific situations the proposed model raises comments:

- Intelligibility of the proposed amendment should be enhanced and definitions revisited in order to be understandable on a standalone basis
- The fair value concentration test may lead to the conclusion of an asset acquisition for situations where one can identify a substantive process. ANC considers more appropriate to turn the test into a rebuttable test instead of leading to a binding conclusion.
- How to link the existence of goodwill with the proposed methodology?
- How to analyze the transfer of an organized workforce?
- Examples may in some instances be misunderstood and can be misleading, due to the way the process of reasoning is presented. In addition, examples focus on a limited number of activities and some examples even though reaching the adequate outcome follow a mode of reasoning that is inconsistent with the standard.

1. Definition of a Business

A – Fair Value concentration test

ANC supports the efforts made to develop a test that would facilitate the identification of situations where the integrated set of activities and assets is not a business.
However, in ANC view, the fair value concentration test should be presented in a more explicit way. ANC considers that paragraphs B8A to B11C are not understandable on a standalone basis and need to

be read in conjunction with the paragraphs BC18-BC21 and the examples (which are not part of the standard). Hence the standard should notably specify:

- **<u>The status of the test</u>**
  IFRS 3 amendments need to be read in conjunction with the Basis for Conclusion to understand that the conclusion of this first step is binding and determines the classification of the transaction[1] (asset versus business combination) without having the possibility to demonstrate, based on facts and circumstances, that the substance of the deal differs.

- **<u>How to perform the fair value concentration test</u>**
  The way to perform the fair value concentration test appears to be unclear in several instances. ANC believes that the standard, as well as the examples provided, should evidence how to perform the test and how to measure the fair value of gross assets. The Exposure Draft presents the measurement of the fair value of the gross assets by adding the fair value of the liabilities acquired to the transaction price as one solution amongst others. ANC believes it should be the way to measure it. Otherwise, one could try to measure it by adding the fair value of individual assets, including non-identifiable ones (like a pre-PPA), which could make the fair value concentration test inoperative. In addition, ANC believes that this test could lead to an inappropriate conclusion in some businesses and activities.
  For these reasons, ANC believes that the screening test should not be a binary test which conclusion cannot be rebutted but should be a test taking into account, at one stage, specific facts and circumstances. Therefore, ANC's stakeholders consider that the screening test could be enhanced as follows:
    - The existence or absence of the workforce transferred should be considered as a criterion to be incorporated in the screening test in order to rebut the conclusion, based on specific facts and circumstances. Indicators could be provided to justify why the screening test conclusion has been rebutted (existence of a workforce, existence of critical side-contracts in the business…). ANC is in favor of this solution as it should be applicable to all types of business.

    - The existence or absence of a workforce transferred could become a key criteria used as a pre-screening test. Such approach would mean that if a workforce exists the screening test should not be required and the second step of the amendment's proposed methodology should be performed.

In ANC's view, acquired integrated set of activities and assets in the Real Estate sector (hotels, shopping centers …), pharmaceutical industry, energy (wind farms), public sector infrastructures (airports) … may, with the revised standard, be unable to qualify as a business. Such conclusion would result from the very high value of the underlying asset when compared to the fair value of the workforce or other inputs.

[1] IFRS 3.BC *"further assessment of whether a set of activities and assets is a business would not be appropriate"*

Hence, ANC believes that the fair value concentration test ("screening test"), as described in the proposed amendment, is excessively rule-based. This remark could be circumvented while giving a rebuttable presumption status to the fair value concentration test instead of proposing a systematic and binary test. In addition, the proposed amendment could be enhanced while being more explicit in the way to implement the test.

B - Transfer of the workforce

Once the fair value concentration test is performed and concludes that further assessment is required to determine if a transaction is a business or not ; then the transfer of the workforce becomes a key criterion that needs to be scrutinized, notably when no output is produced. This criterion raises a set of questions:

- How to concisely define an "organized workforce" and what are the key elements determining that the workforce is a critical process or input? How to link this definition with the definition of a process as described in IFRS 3.B7b (notably relying on the "intellectual capacity" of an organized workforce)? Does it means that manual activities performed by a workforce differ from intellectual activities when determining if a transaction is a business or not?
- In some jurisdictions, legal constraints require to transfer the workforce even though the acquirer does not need the workforce and does not allocate any value to it. How such situation has to be taken into consideration?
- In automated businesses where no employee is required to operate the site: how should the absence of workforce be analyzed?
- Is the workforce an input and/or a process depending on fact and circumstances? It must be noted that IFRS 3.B12.c and IFRS 3 BC 27 states that a contractual arrangement outsourcing activities (outsourced workforce) can be considered as a substantive process whereas IFRS 3.B12.a states *"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 and organized workforce (which is an input) with the necessary skills, knowledge, or experience to perform an acquired substantive process (or group of processes)"* IFRS 3.BC24 also states *"the Board believes that an organized workforce is an input to a business, not a business in itself"*. Hence, ANC understands that IFRS 3.B12.a and IFRS 3 BC24 consider that an organized workforce is an input and can in some instances additionally be a substantive process

ANC believes that even though the existence of a workforce transferred should be an indicator, this criterion should not be predominant. It is key that a judgmental approach is implemented in order to deal with specific situations (such as automated processes for instance).

C – Identifying substantive processes

The proposed approach used to define if a process is substantive in order to determine if an acquisition qualify as a business raises in ANC's view the following comments:

- **Definition of a substantive process**

  ANC considers that the definition of a process is still unclear and has not been redefined. ANC acknowledges that such definition is difficult to reach. However, ANC underlines the fact that the definition of a process may remain a grey zone requiring the interpretation of facts and circumstances and that a judgmental approach is required to determine if a transaction relates to a business or is an asset / group of assets.

- **Goodwill as an indicator of an acquired substantive process**

The presumption that existed in paragraph IFRS 3.B12 considering that the presence of goodwill indicates that the acquired set of activities and assets is a business has been deleted. The presence of goodwill becomes solely an indicator. ANC wonders why the reference to goodwill is maintained and how the presence of goodwill is articulated with the framework developed in IFRS 3B12.a-B12.c. It is unclear as to how to link the goodwill with the output, input and processes analysis: goodwill seems to appear nowhere in the complete decision tree, while maintained as an indicator in the draft amendment.
In addition, the reference to the presence of goodwill proposes in our view a circular approach as the goodwill results from the application of IFRS 3, based on the assumption that the underlying transaction is a business. Goodwill is what remains unallocated after having applied that standard.

ANC considers the reference to the presence of goodwill should be better articulated with the global approach of the revised IFRS 3, or deleted if not compatible.

- **Acquired contracts**

IFRS 3.B12.c states in the proposed amendment: "*an acquired contract is not a substantive process*". It means that the Board considers that the sole contracts that can be considered as a substantive process are outsourcing contracts (outsourced workforce). Considering that a contract is not a substantive process, unless the acquired contract provides access to an organized workforce, is in our view a binary approach. ANC believes that based on facts and circumstances any contract acquired has to be analyzed as an input and/or a process.
Therefore, ANC considers that contractual agreements should all be reviewed in details in order to classify them, based on fact and circumstances, as a process or an input. For instance, suppliers', customers' contracts would probably be viewed as an input. On the other hand manufacturing contracts could be considered as a process or an input.

D - Enhancing the intelligibility of the proposed amendment

ANC considers that the intelligibility of the proposed amendment should be enhanced in order to propose a clear depiction of the process that needs to be implemented to perform the analysis.

ANC considers that presenting a global diagram encompassing all steps from the fair value concentration test, to the assessment of the presence of outputs, inputs and substantive process is desirable.

2. Examples

ANC favors the IASB's efforts to develop application guidance and examples to accompany the proposed amendments. However, ANC considers that these examples could in some instances be difficult to analogize, or could be misleading. In ANC's views the proposed examples should be:

- **More explicit** Fact patterns should be more specific and precise and the IASB should clarify its line of argument while proposing variations of the case in order to capture the complexity of each situation and how judgment is performed.
- **The IASB has developed a model that mostly applies to the industrial sector.**
  Over 11 examples, it must be noted that no example has been developed for the insurance sector, and that only one example has been provided for the banking sector. In addition, ANC's stakeholders in the banking sector consider this example to be outdated and too

simplistic. Hence, ANC considers that the IASB could usefully investigate cases related to the insurance, services, start-ups, fin techs sectors in order to be able to determine if the model can be applied and how it should be implemented.

Below, ANC presents its comments on some of the proposed examples:

A - Acquisition of oil and gas operations (example J)

ANC agrees with the overall conclusion on this example. However, the link between the proposed amendments and the process of reasoning does not clearly appear. In this example, the conclusion states that the transaction is a business relying on the fact that specific assets are transferred. In this case, assets are deemed to represent a substantive operational process. The question that arises is would the same conclusion had been reached applying the strict definition of a process as mentioned in paragraph IFRS 3.B7 "*definition of a process*".

The difficulty is that IFRS 3.B7 does not actually specify that a specific asset can in some instances become or integrate a substantive process. Assets are only described as inputs (IFRS 3.B7.a).

In that example, we understand that when acquiring the entire infrastructure, the investor has only to switch on the system to generate outputs. Does the Board consider that the substantive process is integrated in the infrastructure, through the way the different elements of the infrastructure are interconnected? If so such statement should be explained further, and a guidance applicable to automated set of activities and assets should be developed in order to help identifying whether the integrated process is substantive or not. For example, ANC wonders whether an integrated process is substantive when considering the oil and gas example. The same type of question arises when considering solar or wind farms processes.

The expected guidance should be able to help reaching the adequate conclusion in the following situations: integrated systems, automated production lines (without any workforce), production lines specifically designed to comply with quality standards (e.g. FDA agreements) or to optimize costs.

B - Close-down facility (example D)

The analysis developed in this example concludes that the transaction is not a business relying on the fact that although the transaction includes the transfer of an organized workforce, it does not include any other acquired input that the workforce could convert into outputs.

ANC's first comment is that such example may induce the development of structured transactions aiming at obtaining specific accounting treatments. For instance, in that particular example, would the conclusion be different if some raw material inventories were transferred together with the facility? Those inventories would be seen as an input that the organized workforce can transform to generate outputs. If the conclusion is different, how suppliers' contracts providing raw materials shall be taken into account? Are they an input? What if they are temporarily suspended? And what if the inputs needed by the facility to produce outputs are easily available on the market?

ANC considers that the facts are circumstances presented in this example are not sufficiently detailed to be able to conclude. Facts and circumstances describing the situation should be detailed in order to understand the process of reasoning used to reach the conclusion and avoid the development of bright lines and structured contracts.

It would have also been helpful to propose variations in order to understand when the judgment switches from asset to business.

C - Acquisition of single-family homes (example A), acquisition of investment properties (Example H and I)

Real estate examples do not specify the reasons why the different assets are grouped together and considered to be a single asset. Examples should have evidenced the criterion to be taken into account to group or not assets. However, ANC believes that such analysis should remain principles-based and should not be more detailed in the revised standard.

Furthermore, we believe that examples where the fair value concentration test is positive should be detailed further, with illustrative figures. It shall also explain how to measure the gross assets fair value and how to compare it with the fair value of the main asset / main group of similar assets acquired.

The difference between example H and example I is not straight forward. Actually, conclusions differ due to the fact that the workforce transferred has a significant fair value in example I whereas it hasn't in example H. ANC stakeholders do not understand how the fair value of the organized workforce is assessed and how it can be material compared to the gross fair value of assets acquired.

D - Acquisition of a biotech entity (Example E)

In example E where the acquisition of a biotech entity is analyzed, the screening test does not deal with complex issues as the transaction encompasses the transfer of tangible fixed assets. It must be noted that in the pharmaceutical industry biotech acquisitions can be performed with no significant tangible fixed assets being transferred. Therefore, the acquisition of a biotech can encompass the transfer of a R&D team and a single asset (or combination of similar assets / drug candidates).

ANC considers that it would have been helpful to apply the screening test to this type of situation in order to understand how to take into consideration the fair value of the staff transferred. ANC is not convinced that applying the screening test to this type of transaction would permit accounting the deal as a business combination, even though the transfer of the R&D team is key to complete successfully the development, and therefore would be considered as an acquired substantive process. If our understanding is correct, it is probable that several acquisitions will henceforth qualify as separate assets acquisitions.

E - Acquisition of a drug candidate (example B)

Example B focuses on the acquisition of a drug candidate. However, this example could have been analyzed with a slightly modified and more complex fact pattern.

For instances, in the pharmaceutical industry mature products and the corresponding sales force may be acquired as separate deals. In addition, those acquisitions are often accompanied by a set of other contracts such as: supply contracts, outsourcing contracts, manufacturing contracts, license on a technology used for the development of the compound, transition period contract, distribution contracts…

ANC understands that in such situation, the screening test considers that a single asset has been acquired. In this situation, the fair value of the workforce is considered to be nil as it is outsourced in a contract at market price. Hence, the transaction will probably not qualify as a business combination but as a separate asset. If ANC understanding is correct this conclusion appears to be counter-intuitive as the product acquired is a mature product generating outputs relying on a significant and critical workforce as well as on supply/manufacturing contracts. Moreover, such conclusion would probably change the existing accounting practice.

Hence, ANC believes that the IASB staff should have considered the effects of the proposed amendment on such specific situation where the workforce is critical but has no intrinsic value (as employees are paid at market price).

Question 2 – 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.

Do you have any comments regarding the differences in the proposals, including any difference in practice that could emerge as a result of the different wording?

EFRAG – Do you anticipate any difference in practice in applying IFRS or US GAAP as a result of the differences in wording?

1. Effects of amendments' divergences between US GAAP and IFRS

ANC supports EFRAG's response encouraging the IASB and the FASB to reach converged solutions on their respective proposed amendments as long as the standards developed remain compatible with IFRS principles. For this reason, ANC considers more appropriate to turn the concentration test into a rebuttable presumption instead of proposing a binding conclusion.

As regards the rest of the amendment, ANC believes that the closer the wording between the two proposals is, the better the IFRS 3 convergence will be. In this respect, ANC considers that the IASB should make its best efforts to conduct Post Implementation Reviews and subsequent amendments of "twin" standards according to a timeline that is similar to that of the FASB. Otherwise, the objective of maintaining the convergence of the standard would lead the Board to propose amendments decided by the FASB, without being able to provide the FASB with comments arising from IFRS stakeholders.

Following FASB's Exposure Draft comment period ending in August 2016, several needs for clarification have arisen from the US GAAP comment letters.

2. US GAAP and IFRS differences in the design of the project

The FASB project is being addressed in three phases (see FASB ED BC4 and BC5):

- Clarification of the definition of a business (project currently discussed)
- Scope of asset de-recognition guidance and accounting for partial sales (separate project)
- Other assets versus business accounting differences (not started yet)

As regards partial de-recognition of assets outside the scope of a "business", ANC's stakeholders consider that such implementation issue should also be analyzed and discussed in the IFRS environment. Even though ANC acknowledges the fact that these transactions are not part of the initial IFRS 3 convergence project, it considers that the standards dealing with these issues should be discussed in order to determine if clarifications are required and how to account for the derecognition or step-derecognition of certain assets. Some stakeholders underlined the fact that a subsidiary may not be, in some instances, a business; or that some Special Purpose Entities encompassing assets and liabilities may not qualify anymore for a business. Hence, such transactions will be booked as an asset when applying the revised IFRS 3. Those stakeholders assume that the application of the revised IFRS 3 will significantly increase the number of transactions facing this situation.

In addition, and in line with the FASB third phase of the project, ANC considers that the differences between asset accounting and business accounting should be questioned as regards IFRS, in order to identify if clarifications or changes are required.

Question 3 – To address diversity of practice regarding acquisitions of interests in businesses that are joint operations, the Board is proposing to add paragraph 42 A to IFRS 3 and amend paragraph B33C of IFRS 11 to clarify that:

(a) On obtaining control, an entity should re-measure previously held interests in the assets and liabilities of the joint operation in the manner described in paragraph 42 of IFRS 3; and
(b) On obtaining joint control, an entity should not re-measure previously held interests in the assets and liabilities of the joint operation.

Do you agree with these proposed amendments to IFRS 3 and IFRS 11? If not, what alternative would you propose, if any, and why?

ANC concurs with EFRAG to support the IASB's proposal aiming at clarifying the accounting for previously held interests in the assets and liabilities of a joint operation when an entity obtains control over a joint operation meeting the definition of a business.

ANC believes that situations where such provisions apply are rare. However, in the rare cases where this situation may arise, this amendment proposes a consistent approach with the current IFRS 3 general principle for step acquisitions.

ANC underlines the fact that §55 of the proposed EFRAG's comment letter is misleading as the June 2016 Exposure Draft BC3 states *"when an entity obtains control of a business that is a joint operation"* and not *"when an investor obtains joint control of a business that is a joint operation"*. BC3 refers to obtaining control and not joint control. Such quote should be accordingly amended in paragraph 55 of the EFRAG's draft comment letter.

Question 4 – The Board is proposing the amendments to IFRS 3 and IFRS 11 to clarify the guidance on the definition of a business and the accounting for previously held interests be applied prospectively with early application permitted.

Do you agree with these proposed transition requirements? Why or why not?

ANC supports the proposal to apply prospectively the amendments and to authorize early application once published. In addition, ANC underlines that these amendments will only apply to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after (effective date). Hence ANC understands that applying a prospective approach will permit not changing the current IFRS 3 classification between assets and business. Such proposal is consistent with the first application of the revised IFRS 3 considering that costs for preparers to retrospectively apply the amendments would outweigh the benefits to users.