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Definition of a Business and Accounting for Previously Held Interests

Issues paper

Background

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

2 In November 2015, the US Financial Accounting Standards Board (FASB) published the Proposed Accounting Standards Update *Clarifying the Definition of a Business* which included proposals similar to those proposed by the IASB. The FASB finalised its project in January 2017 and issued Update 2017-01 - *Clarifying the Definition of a Business.*

Purpose of this paper

3 This paper considers two topics:

(a) Topic 1 - the comments received from respondents, including ASAF members, on the proposed screening test; which considers a set of activities and assets not to be a business if the fair value of the gross assets acquired is concentrated in a single asset or group of similar assets. The proposed screening test attracted the greatest level of attention, including from ASAF members, in the comment letters received. It was also the part of the proposed amendments that concerned EFRAG the most.

(b) Topic 2 - Provides a summary of the feedback the IASB received on the proposed amendments included in the ED. The IASB will discuss the feedback received at its meeting on 23 February 2017. The IASB Staff will provide a more detailed analysis of the comments received and Staff recommendations on how to proceed with the project at a future IASB meeting.

Topic 1 - The proposed screening test

4 The IASB proposed 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. In the view of the IASB, a determinative screening test would reduce the cost of applying the definition of a business without changing the IASB's intended outcome.

5 The IASB also proposed to clarify that:

(a) the fair value of the gross assets acquired includes the fair value of any acquired input, contract, process, workforce and all other intangible assets, including those that are not identifiable; and

(b) the fair value of the gross assets acquired may be determined by adding the fair value of the liabilities assumed to the fair value of the consideration paid (plus the fair value of any non-controlling interest and any previously held interest, if any).

6 Many respondents, including EFRAG, generally agreed that the proposed screening test could serve as a practical solution that, in some cases, simplifies the assessment of whether an acquisition is a business combination or an asset acquisition. However many of these respondents expressed concerns or requested further clarification on the proposed screening test. Specifically respondents noted that:

(a) the screening test may result in inappropriate conclusions;

(b) requested additional guidance on whether deferred taxes should be included in the fair value of the gross assets acquired; and

(c) requested additional guidance on the meaning of ´similar assets´.

The screening test may result in inappropriate conclusions

7 Some respondents to the IASB ED, including EFRAG and other ASAF members, commented that the proposed screening test tends to be rules-based, does not allow the exercise of judgement and may sometimes result in inappropriate conclusions (ie 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).

8 For example, respondents noted that, acquisitions of a fully-leased shopping mall including employees, or a fund are most likely to include one significant asset (the property for the mall) or a group of similar assets (the financial assets for the fund) and processes that are outsourced (property management, asset management, etc) which might be considered substantive, and the acquired set in each case is capable of producing outputs. However, both cases are likely to pass the screening test and would not be considered a business under the proposals.

9 Specifically EFRAG noted that:

EFRAG appreciates the difficulties in drafting a screening test that is easy to apply, addresses concerns that the existing definition of a business captures some asset acquisitions and reaches the appropriate conclusion in every possible set of facts and circumstances. However, we are concerned that, as currently drafted, the screening test may, in some instances, result in inappropriate conclusions. EFRAG believes that the screening test should be retained as a determinative assessment only if its relative simplicity can be maintained while avoiding inappropriate outcomes.

10 If EFRAG's suggestion cannot be accomplished, 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 suggests 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.

11 Like EFRAG, a number of respondents suggested improvements to the screening test which included:

(a) changing the screening test from a quantitative preliminary pass / fail test to one of the following: i) an optional test, or ii) a test that considers both qualitative and quantitative factors;

(b) 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; and

(c) outsourcing contracts should be considered separately in order to avoid inappropriate outcomes.

Whether deferred taxes should be included in the fair value of the gross assets acquired

12 Some respondents, including EFRAG, suggested that the IASB consider excluding the effects of deferred tax from the screening test, on the basis that the tax attributes of the acquired assets and liabilities should not influence the outcome of the test.

13 Furthermore, the EFRAG Secretariat notes that if deferred tax liabilities are not excluded, the entity will be required to fair value the assets acquired in determining the fair value of the gross assets acquired, and thus the simplicity of the screening is lost.

Meaning of ´similar assets´

14 Some respondents, including EFRAG, observed that additional guidance would be needed to determine when it is appropriate to combine assets into a single identifiable asset and what would be considered ´similar´.

15 These respondents that the ED did not define the term ´similar´, and only indicated in paragraph B11C assets that shall not be combined into a single identifiable asset or considered a group of similar identifiable assets. EFRAG, for example, recommended that the IASB articulate in a more principle-based manner when assets can be deemed similar for this purpose. This should clarify which factors play a role in the assessment (for example, that the nature, risks and characteristics of the assets should be similar) without broadening the scope of the proposed screening test.

The FASB decision

16 During its redeliberations the FASB confirmed that the screening test should be determinative and provided some clarifications. When applying the test, the FASB clarified that:

(a) a single identifiable asset includes any asset that could be recognized and measured as a single identifiable asset under Topic 805, Business Combinations, for financial reporting purposes with the following exceptions:

(i) a tangible asset that is attached to and cannot be physically removed and used separately from other tangible assets (or intangible asset representing the right to use a tangible asset), without incurring significant cost, significant diminution in utility, or fair value to either asset; and

(ii) in-place lease intangible assets (including favorable or unfavorable lease assets and liabilities) and related real estate assets should be considered a single asset.

(b) deferred tax assets and the effects of deferred tax liabilities should be excluded from the gross assets acquired; and

(c) identifiable assets within the same major asset class that have significantly different risk characteristics should not be considered similar assets.

17 The EFRAG Secretariat notes that the IASB ED included the clarification in paragraph 16(a) (i) and (ii) above, but not the clarifications in paragraph 16 (b) and (c) above. When responding to the proposals in the ED, EFRAG, and other respondents, recommended that the IASB consider including (b) relating to excluding the effects of deferred taxes from gross assets acquired, and the clarification in (c) as a possible solution to articulate in a principled-based manner when assets can be deemed similar when applying the screening test.

Questions for EFRAG CFSS and EFRAG TEG

18 What advice do EFRAG CFSS and TEG members have for the IASB in respect of:

(a) The comments received on whether the screening test should be determinative or a rebuttable presumption or an indicator?

(b) The requests for further guidance on the meaning of 'similar assets' as noted in paragraph 15?

(c) The suggestion made some respondents, including EFRAG, that deferred tax assets and deferred tax liabilities should be excluded from the gross assets acquired?

Topic 2 - Summary of the feedback on the ED

19 The proposed amendments to the definition of a business were discussed with Accounting Standards Advisory Forum (ASAF) members in September and with Global Preparers Forum (GPF) members in November 2016. The summary included in the paragraphs below includes feedback from ASAF and the GPF.

20 The IASB received 80 comment letters. The IASB will discuss the feedback received at its meeting on 23 February 2017.

21 In summary, most respondents agreed with the IASB's proposals to:

(a) clarify that to be a business a set of assets and activities must include, at a minimum, an input and a substantive process that together contribute to the ability to create outputs;

(b) remove from paragraph B8 of IFRS 3 the statement that a set of activities and assets is a business if market participants can replace the missing elements and continue to produce outputs;

(c) narrow the definition of output to focus on goods and services provided to customers, investment income or other revenues;

(d) 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) provide guidance on identifying a substantive process;

(f) specify that presence of an insignificant amount of goodwill does not mean that the acquired assets should automatically be considered a business; and

(g) not require an entity to apply the proposed amendments to transactions that occur before the effective date of the amendments.

22 Notwithstanding the above, many respondents, including EFRAG, and some other ASAF members, expressed concerns or requested clarification on the proposed screening test. In addition, several respondents, including EFRAG, requested further clarification and made recommendations on other key areas of the ED, namely:

(a) some respondents observed that the assessment of whether a substantive process exists may be complex to apply and highly judgemental. A number of suggestions were made by respondents to simplify the assessment. EFRAG, asked the IASB to provide additional guidance to help entities assess whether an acquired contract gives access to an acquired workforce;

(b) some respondents and some GPF members asked the IASB to clarify the guidance provided in paragraph B12C on acquired outsourcing agreements, with some respondents recommending that the IASB provide an example to illustrate how this guidance can be applied; and

(c) some respondents and some ASAF members observed that the examples should be improved. EFRAG, in its comment letter, made a similar remark.

23 The IASB Staff will discuss a more detailed analysis of the feedback together with Staff recommendations on how to proceed with the project at a future IASB meeting.

Question for EFRAG CFSS and EFRAG TEG

24 At this stage, do EFRAG CFSS and TEG members have any questions or comments on the above summary of feedback received?