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IFRS in Focus
IASB amends the definition of a business in IFRS 3

Contents

This *IFRS in Focus* addresses the recent amendments to IFRS 3 *Business Combinations* that have been published by the International Accounting Standards Board (IASB). The amendments are titled *Definition of a Business—Amendments to IFRS 3*.

- The amendments mean that, 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 significantly contribute to the ability to create** outputs.

- Additional guidance is introduced that helps to determine whether a substantive process has been acquired. New illustrative examples assist with the interpretation of what is considered a business.

- The IASB has removed the assessment of whether market participants are capable of replacing any missing inputs or processes and continuing to produce outputs.

- The definitions of a business and of outputs are narrowed by focusing on goods and services provided to customers. The reference to an ability to reduce costs is removed.

- The IASB has introduced an optional concentration test that permits a simplified assessment of whether an acquired set of activities and assets is not a business—it is not a business 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 amendments are applied prospectively to all business combinations and asset acquisitions for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2020, with earlier application permitted.

Background

The IASB's post-implementation review (PIR) of IFRS 3 revealed that many stakeholders have concerns about how to interpret and apply the definition of a business when applying IFRS 3. As the accounting requirements for goodwill, acquisition costs and deferred tax differ between the acquisition of a business and on the acquisition of a group of assets, the IASB responded to the concerns by issuing these amendments aimed at clarifying the definition of a business.

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

Observation
IFRS 3 and the corresponding US GAAP requirements (SFAS 141(R)) are substantially converged. With regard to the definition of a business, the PIR of SFAS 141(R) revealed similar issues as the PIR of IFRS 3. Consequently, in 2017 the US Financial Accounting Standards Board (FASB) amended US GAAP.

Although the IASB's amendments to IFRS 3 are based on similar conclusions as the US GAAP amendments, they differ in some respects. However, the IASB expects that the amendments will lead to more consistency in applying the definition of a business across entities applying IFRS and entities applying US GAAP.

The amendments

Minimum requirements to meet the definition of a business

The amendments clarify that while businesses usually have outputs, outputs are not required for an integrated set of activities and assets to qualify as a business. However, to meet the definition of a business, an integrated set of activities and assets must include, as a minimum, an input and a substantive process that together significantly contribute to the ability to create output. The IASB also clarifies that outputs in and of themselves are not sufficient to determine that an integrated set of activities and assets is a business. Instead, the entity needs to demonstrate that both an input and a substantive process have been acquired.

To clarify that a business can exist without including all of the inputs and processes needed to create outputs, the IASB replaced the term 'ability to create outputs' with 'ability to contribute to the creation of outputs'.

Assessing whether an acquired process is substantive

To determine whether an acquired process is substantive, different criteria apply, depending on whether there are outputs at the acquisition date.

For integrated sets of activities and assets that **have** outputs at the acquisition date (i.e. those that generate revenue at the acquisition date), an acquired process is substantive in **either** one of the following two scenarios:

(a) The process is critical to the ability to continue producing outputs, and the inputs acquired include an organised workforce with necessary skills, knowledge or experience to perform that process (or group of processes)

(b) The process significantly contributes to the ability to continue producing outputs and is considered unique or scarce or cannot be replaced without significant cost, effort or delay in the ability to continue producing outputs

For integrated sets of activities and assets that **do not have** outputs at the acquisition date, an acquired process is considered substantive if **both** of the following criteria are met:

(a) The process is critical to the ability to develop or convert an acquired input or inputs into outputs

(b) The inputs acquired include both an organised workforce that has the necessary skills, knowledge or experience to perform that process (or group of processes) and other inputs that the workforce could develop or convert into outputs

The IASB has added several examples to the Illustrative Examples of IFRS 3 to demonstrate how the new guidance is applied in certain scenarios.

Observation
The IASB notes that an acquired contract is an input and not a substantive process. However, an acquired contract can give access to an organised workforce which, in turn, performs a substantive process that the entity controls and thus has acquired.

Market participant's ability to replace missing elements

Before the amendments, IFRS 3 stated that a business did not need to include all of the inputs or processes that the seller used in operating the business if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes.

The IASB has now removed this reference as participants in the PIR of IFRS 3 have indicated that it is challenging to assess whether market participants are capable of performing such an integration. Instead, as described above, the IASB decided to focus on whether acquired inputs and acquired substantive processes together significantly contribute to the ability to create outputs.

Narrowed definition of outputs

To narrow the definition of outputs, the IASB has amended the definition of a business in Appendix A of IFRS 3 as well as the definition of outputs in the Application Guidance to IFRS 3. These amendments put the focus of outputs on goods and services provided to customers. By that, the IASB wants to achieve consistency with the notion of outputs in IFRS 15 *Revenue from Contracts with Customers.*

The amendments remove from the new definitions references to returns in the form of lower costs and other economic benefits provided directly to investors or other owners, members or participants. In the IASB's view, the reduction of costs is not a helpful concept to distinguish between acquisitions of a business and asset acquisitions. Many asset acquisitions that do not include a substantive process may also be made with the motive of lowering costs.

Optional test to identify concentration of fair value

The IASB has introduced an optional test that provides a simplified assessment of whether an acquired set of activities and assets is not a business (the concentration test). If the concentration test is met, the set of activities and assets is determined not to be a business and no further assessment is needed. If the test is not met, an entity performs the assessment set out above to determine whether or not the acquired set of activities and assets is a business.

The concentration test is met 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 IASB decided to focus on gross assets rather than net assets in the test as the existence of debt or other liabilities has no relevance on whether an acquisition is a business combination. In addition, the concentration test excludes cash and cash equivalents acquired, deferred tax assets and goodwill resulting from the effects of deferred tax liabilities. Those items are independent of whether the acquired set of activities and assets includes a substantive process.

An example of how the test is performed is added to the Illustrative Examples that accompany IFRS 3.

Observation

In the Basis for Conclusions to the amendments, the IASB concedes that, in theory, the concentration test might sometimes identify a transaction as an asset acquisition when the detailed assessment would identify it as a business combination. The test is designed to keep these instances to a minimum, however, if a 'false positive' occurs, the entity fails to recognise goodwill that is economically present. The IASB points out that this goodwill would not be a substantial part of the fair value of the gross assets acquired, as otherwise the test would have been negative.

Effective Date

An entity shall apply the amendments to business combinations and asset acquisitions that occur on or after the beginning of the first annual reporting period beginning on or after 1 January 2020. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact.

Further information

If you have any questions about the amendments to IFRS 3, please speak to your usual Deloitte contact or get in touch with a contact identified in this *IFRS in Focus.*

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