International Financial Reporting Standard

Definition of a Business

December 2018

BASIS FOR CONCLUSIONS – AMENDMENTS

[IFRS 3]

[Related to AASB 2018-6]

Amendments to the Basis for Conclusions on IFRS 3 *Business Combinations*

After paragraph BC21, new headings and paragraphs BC21A–BC21AC are added.

Clarifying the definition of a business

BC21A Following a Post-implementation Review (PIR) of IFRS 3, the Board noted that many stakeholders had concerns about how to interpret and apply the definition of a business. Stakeholders indicated that these concerns arose for one or more of the following main reasons:

(a) IFRS 3 requires a fact-driven assessment that adopts the perspective of market participants and does not consider the business rationale, strategic considerations and objectives of the acquirer (see paragraph BC21G);

(b) some sets of activities and assets might have been considered a business from the perspective of particular market participants who could integrate the set in their processes. However, the same sets of activities and assets might not have been considered a business from the perspective of other market participants (see paragraphs BC21H–BC21I);

(c) the definition of a business used the wording 'capable of being conducted and managed for the purpose of providing' a return. That wording did not help in determining whether a transaction includes a business (see paragraphs BC21J–BC21K);

(d) it was difficult to assess:

(i) whether the processes acquired are sufficient to constitute one of the elements required for an acquired set of activities and assets to be a business, and whether any missing processes are so significant that the set is not a business; and

(ii) how to apply the definition of a business if the acquired set of activities and assets does not generate revenue (see paragraphs BC21L–BC21R); and

(e) the definition of a business was broad and IFRS 3 had no guidance identifying when an acquired set of activities and assets is not a business (see paragraphs BC21S–BC21AC).

BC21B To consider those concerns, the Board added to its agenda a project to clarify the definition of a business, with the objective of assisting entities to determine whether a transaction should be accounted for as a business combination or as an asset acquisition. In 2016 the Board published an exposure draft *Definition of a Business and Accounting for Previously Held Interests* (2016 Exposure Draft). The 2016 Exposure Draft attracted 80 comment letters. The Board reviewed those comment letters and consulted the Accounting Standards Advisory Forum (ASAF), the Capital Markets Advisory Committee and the Global Preparers Forum. In 2018 the Board issued *Definition of a Business* (2018 Amendments). In the 2018 Amendments, the Board:

(a) clarified 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 (see paragraph BC21F);

(b) removed the assessment of whether market participants are capable of replacing any missing inputs or processes and continuing to produce outputs (see paragraphs BC21H–BC21I);

(c) added guidance and illustrative examples to help entities assess whether a substantive process has been acquired (see paragraphs BC21L–BC21R);

(d) narrowed the definitions of a business and of outputs by focusing on goods and services provided to customers and by removing the reference to an ability to reduce costs (see paragraph BC21S);

(e) added an optional concentration test that permits a simplified assessment of whether an acquired set of activities and assets is not a business (see paragraphs BC21T–BC21AC); and

(f) decided that an entity is permitted but not required to apply the amendments to transactions that occurred before the effective date of the amendments. Retrospective application of the amendments to earlier transactions is not required because it is unlikely to provide useful information to users of financial statements, could have been costly and could have been impracticable if hindsight were to be needed. Retrospective application was not prohibited because there may be instances when it would provide useful information and because when it is used it would not deprive users of useful information.

BC21C The 2016 Exposure Draft also dealt with a second topic, accounting for previously held interests. The Board finalised its work on that topic, among others, in 2017 by issuing *Annual Improvements to IFRS Standards 2015–2017 Cycle*.

BC21D IFRS 3 is the result of a joint project between the Board and the FASB and it contained the same definition of a business as the definition in US GAAP. The PIR of IFRS 3 and a PIR of SFAS 141(R) identified similar difficulties in applying the definition of a business. Moreover, the FASB received feedback from many stakeholders that the definition of a business in US GAAP was, in practice, viewed as capturing a broader range of transactions than the identical definition in IFRS 3. Consequently, the FASB amended US GAAP in 2017 by issuing Accounting Standards Update No. 2017-01 *Clarifying the Definition of a Business* (FASB 2017 Amendments). The 2018 Amendments addressed the issues identified during the PIR of IFRS 3 and, though worded differently, are based on conclusions similar to those reached by the FASB. The Board concluded that its 2018 Amendments and the FASB 2017 Amendments could together be expected to lead to more consistency in applying the definition of a business across entities applying US GAAP and entities applying IFRS Standards.

BC21E The 2018 Amendments differ in some respects from the FASB 2017 Amendments. Before finalising the 2018 Amendments, the Board discussed those differences with ASAF. The differences are as follows:

(a) the concentration test set out in paragraphs B7A–B7B of IFRS 3 is optional. The corresponding test in the FASB 2017 Amendments is mandatory. The guidance on how to identify concentration of fair value is substantially the same, but the Board added confirmation of the calculations normally needed (see paragraph B7B(b)) and an illustrative example (Example I).

(b) the Board concluded that an acquired outsourcing contract may give access to an organised workforce that performs a substantive process, even if the acquired set of activities and assets has no outputs. 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 has been acquired only if the acquired set includes an organised workforce made up of employees.

(c) the Board clarified in paragraph B12D that difficulties in replacing an organised workforce may indicate that the organised workforce performs a process that is critical to the ability to create outputs. The FASB 2017 Amendments do not include this clarification.

(d) the FASB 2017 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 Board did not include such a statement in the 2018 Amendments (see paragraph BC21R(d)).

(e) the Board clarified in paragraph B7(c) of IFRS 3 that the narrowed definition of outputs includes other income from ordinary activities. An example of such other income is income from contracts outside the scope of IFRS 15 *Revenue from Contracts with Customers*. The FASB expressed a similar view as an observation in its Basis for Conclusions.

(f) the Board aligned the definition of a business with the revised definition of outputs in paragraph B7(c) of IFRS 3. The FASB did not align the two definitions, but its definition of a business refers explicitly to supporting guidance, including guidance on outputs.

Minimum requirements to be a business

BC21F The existence of a process (or processes) is what distinguishes a business from a set of activities and assets that is not a business. Consequently, the Board decided 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. The Board incorporated this requirement in paragraph B8. To clarify that a business can exist without including all of the inputs and processes needed to create outputs, the Board replaced the term 'ability to create outputs' with 'ability to contribute to the creation of outputs' in paragraph B7 of IFRS 3.

Market participant's perspective

BC21G Paragraph B11 of IFRS 3 adopts a market participant's perspective in determining whether an acquired set of activities and assets is a business. Some participants in the PIR of IFRS 3 noted that adopting that perspective requires a fact-driven assessment that does not consider the business rationale, strategic considerations and objectives of the acquirer. They expressed concerns that excluding those factors would not result in the most useful information for users of financial statements. Nevertheless, the Board concluded that the assessment should continue to be made from a market participant's perspective and to be driven by facts that indicate the current state and condition of what has been acquired, rather than by considering what the acquirer might intend to do with the acquired set of activities and assets. Basing this determination on facts, rather than on the intentions of the acquirer, helps to prevent similar transactions being accounted for differently. In the Board's view, bringing the business rationale, strategic considerations and objectives of the acquirer into the determination would have made the determination more subjective and thus would have increased diversity in practice. Consequently, the Board did not change paragraph B11 in this regard.

Market participant's ability to replace missing elements

BC21H Before the 2018 Amendments, paragraph B8 of IFRS 3 stated that a business need not include all of the inputs or processes that the seller used in operating that 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'. Many participants in the PIR of IFRS 3 stated that it can be challenging to assess whether market participants are capable of performing such an integration, especially if only some market participants are capable of performing such an integration.

BC21I In the light of those comments, the Board decided to base the assessment on what has been acquired in its current state and condition, rather than on whether market participants would be capable of replacing any missing inputs or processes, for example by integrating the acquired activities and assets. Therefore, the Board deleted the reference to such integration. Instead, as discussed in paragraph BC21F, the 2018 Amendments focus on whether acquired inputs and acquired substantive processes together significantly contribute to the ability to create outputs.

The term 'capable of' in the definition of a business

BC21J The definition of a business includes the phrase 'capable of being conducted and managed for the purpose of providing' a return. Many participants in the PIR indicated that this phrase was too broad in scope to be helpful in distinguishing businesses from assets. However, the Board concluded that it was not necessary to change or clarify this phrase because the 2018 Amendments:

(a) removed the assessment of whether market participants are capable of integrating the acquired activities and assets;

(b) clarified that the acquired processes need to be substantive;

(c) narrowed the definition of output; and

(d) added more robust guidance and illustrative examples supporting various aspects of the definition.

BC21K The Board considered whether additional guidance was needed regarding the acquisition of suppliers. In some cases, the acquirer integrates an acquired business with the result that it no longer generates revenue. For example, an entity may acquire a supplier and subsequently consume all the output from the supplier. The acquired inputs and processes are still 'capable of' generating revenue at the acquisition date and so could qualify as a business, if the criteria in paragraph B12C are met. The Board concluded that this outcome was appropriate because the assessment focuses on what the acquirer acquired, not on what the acquirer intends to do with what it acquired. Accordingly, the Board retained the term 'capable of' as the basis for assessment.

Assessing whether an acquired process is substantive

BC21L Many participants in the PIR of IFRS 3 stated that it is difficult to assess:

(a) whether the processes acquired are sufficient to constitute one of the elements required for an acquired set of activities and assets to be a business;

(b) whether any processes missing from that set are so significant that the set is not a business; and

(c) how to apply the definition of a business when the acquired set of assets does not generate revenue.

BC21M To address these concerns, the 2018 Amendments added guidance to help entities to assess whether an acquired process is substantive. That guidance seeks more persuasive evidence when there are no outputs because the existence of outputs already provides some evidence that the acquired set of activities and assets is a business. In particular, if the set has no outputs at the acquisition date, the inputs acquired must include:

(a) an organised workforce that meets specified criteria (see paragraphs BC21N–BC21P); and

(b) other inputs that the organised workforce could develop or convert into outputs (see paragraph BC21Q)

BC21N The Board concluded that the presence of an organised workforce is an indicator of a substantive process. Consequently, the Board decided that, except in limited circumstances, an organised workforce is required in order to conclude that the set of activities and assets is a business. The limited circumstances are when the acquired set both:

(a) has outputs; and

(b) includes a process (or a group of processes) that is unique or scarce, or cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs. The Board concluded that such processes are usually valuable and that this would often indicate that the processes are substantive, even if no organised workforce is acquired.

BC21O The Board concluded that although an organised workforce is an input to a business, it is not in itself a business. To conclude otherwise would mean that hiring a skilled employee without acquiring any other inputs could be considered to be acquiring a business. The Board decided that such an outcome would be inconsistent with the definition of a business.

BC21P Although the Board concluded that an organised workforce is an input, paragraph B7(b) indicates that the intellectual capacity of an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. The Board concluded that this is the case even if the processes are not documented. The Board inserted the phrase 'intellectual capacity' to provide clarity.

BC21Q For an acquired set of activities and assets to be considered a business if the set has no outputs, the Board concluded that the set should include not only a substantive process but also both an organised workforce and other inputs that the acquired organised workforce could develop or convert into outputs. Entities will need to evaluate the nature of those inputs to assess whether that process is substantive. The Board observed that many entities in the development stage will meet this criterion because technology, intellectual property, or other assets are being developed into a good or service. Conversely, if a set is producing outputs at the acquisition date, the set already contains inputs that are being converted into outputs, and, therefore, there is no need to consider specifically the type of inputs to which the acquired process is applied.

BC21R In finalising the 2018 Amendments, the Board also:

(a) specified in paragraph B12D(a) that an acquired contract is not a substantive process, in order to clarify that a contract that provides a continuing revenue stream (eg a lease contract) is not itself a process.

(b) clarified in paragraph B12D(a) that an acquired outsourcing agreement may give access to an organised workforce and that an entity should assess whether an organised workforce accessed through an outsourcing arrangement performs a substantive process that the entity controls, and thus has acquired. The Board added this paragraph because some IFRS Interpretations Committee members observed that IFRS 3 did not provide guidance on whether an outsourced process should be considered in assessing whether a set of activities and assets is a business.

(c) clarified in paragraph B12D(b) that difficulties in replacing an acquired organised workforce may indicate that the organised workforce performs a process that is critical to the ability to create outputs, because the Board expected that it would normally be more difficult to replace a workforce that performs a critical process than to replace a workforce that performs, for example, an ancillary process. The Board provided this indicator because some respondents to the 2016 Exposure Draft commented that the proposed guidance on substantive processes would require too much judgement.

(d) removed the presumption, proposed in the 2016 Exposure Draft, that the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive. Responses to the 2016 Exposure Draft showed that this proposal created more confusion than clarity. For example, some respondents were unclear whether this proposal referred to 'core goodwill' that is economically present in a business, or to the accounting measurement of goodwill that is determined in accounting for business combinations. Some respondents wondered whether this proposal would, in effect, force entities to apply business combination accounting to measure goodwill in order to assess whether what was acquired was in fact a business.

(e) deleted paragraph B10 of IFRS 3, which described factors to consider when assessing an integrated set of activities and assets in the development stage. The Board deleted that paragraph because the 2018 Amendments provide a more general discussion of acquired sets of activities and assets that do not have outputs.

(f) added illustrative examples in paragraphs IE73–IE123 to assist with the interpretation of what is considered a business. The draft illustrative examples in the 2016 Exposure Draft also included an example on the acquisition of oil and gas operations. To be consistent with the FASB 2017 Amendments, the Board did not include that example in the 2018 Amendments.

Narrowed definition of outputs

BC21S In the 2018 Amendments, the Board narrowed the definition of outputs to focus on goods and services provided to customers, investment returns and other income from ordinary activities and to exclude returns in the form of lower costs, and other economic benefits provided directly to investors or other owners, members, or participants. The Board also amended the definition of a business to make it consistent with the narrowed definition of outputs. The Board made these changes because:

(a) IFRS 15 *Revenue from Contracts with Customers* focuses on goods or services that are an output of an entity's ordinary activities. Nevertheless, because not all businesses have revenue within the scope of IFRS 15, the revised definition also includes outputs that are investment income or other income from ordinary activities.

(b) the previous definition of outputs referred to lower costs and economic benefits provided directly to investors. This reference did not help to distinguish between an asset and a business, because it confused motives for acquiring an asset with the characteristics of the activities and assets acquired. Many asset acquisitions (for example, the purchase of new manufacturing equipment) may be made with the motive of lowering costs but may not involve acquiring a substantive process.

Concentration test

BC21T Many participants in the PIR of IFRS 3 noted that applying the definition of a business involves significant judgements and that IFRS 3 provided little or no guidance that identifies situations in which an acquired set of activities and assets is not a business. To address these concerns, in the 2018 Amendments the Board added a concentration test that is designed to reduce cost and complexity by avoiding the need for a detailed assessment in some circumstances. 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 concentration test is met and the set of activities and assets is considered not to be a business. If the concentration test is met, no further assessment is needed.

BC21U The Board designed the concentration test with the aim of making it easy to understand and—in some straightforward cases that are easy to explain—simple to operate and less costly than applying the detailed assessment otherwise required by paragraphs B8–B12D. To target that aim, the concentration test focuses on a single identifiable asset or a single group of similar identifiable assets. The Board did not expect entities to carry out detailed calculations to apply the test, because detailed calculations would have frustrated the purpose of the test, which is to permit a simplified assessment. In addition, the Board wanted the test to have the same outcome in most circumstances as the detailed assessment and wanted to minimise the risk that the outcome of applying the concentration test could deprive users of financial statements of useful information.

BC21V To confirm that the Board did not expect detailed calculations, paragraph B7B(b) clarifies how the fair value of the gross assets acquired may normally be determined by reference to the fair value of the consideration transferred. In finalising the 2018 Amendments, the Board added an illustrative example showing that calculation (Example I).

BC21W The Board concluded that whether a set of activities and assets includes a substantive process does not depend on how the set is financed. Consequently, the concentration test is based on the gross assets acquired, not on net assets. Thus, the existence of debt (for example, a mortgage loan financing a building) or other liabilities does not alter the conclusion on whether an acquisition is a business combination. In addition, in response to requests from respondents, the Board specified, in finalising the 2018 Amendments, that the gross assets considered in the concentration test exclude cash and cash equivalents acquired, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. These exclusions were made because cash acquired, and the tax base of the assets and liabilities acquired, are independent of whether the acquired set of activities and assets includes a substantive process.

BC21X In finalising the 2018 Amendments, the Board made the concentration test optional. This change enables entities to assess whether they have acquired a substantive process when, for example, such an assessment would be more efficient than applying the concentration test, or would result in a conclusion that more faithfully represents the economics of a particular transaction. In line with the purpose of the concentration test, the 2018 Amendments:

(a) specify that the election to carry out that test is available transaction by transaction; and

(b) do not prohibit an entity from carrying out the detailed assessment required by paragraphs B8–B12D if the entity has carried out the concentration test and concluded that the acquired set of activities and assets is not a business. The Board decided that such a prohibition was unnecessary, because if an entity intended to disregard the outcome of the concentration test, it could have elected not to apply it.

BC21Y In making the concentration test optional, the Board considered the accounting consequences that would occur if, when applied to a particular transaction, the concentration test does not achieve the same outcome as the detailed assessment otherwise required by paragraphs B8–B12D. The concentration test identifies some transactions as an asset acquisition. For all other transactions, the entity must go on to perform the detailed assessment. The concentration test never determines that a transaction is a business combination.

BC21Z 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. That outcome would be a false positive. The Board designed the concentration test to minimise the risk that a false positive could deprive users of financial statements of useful information. A false positive has two consequences:

(a) the entity fails to recognise 'core goodwill' that is economically present in a business combination but is not present in an asset acquisition.[1] Nevertheless, if substantially all of the fair value of the gross assets acquired (including core goodwill) is concentrated in a single identifiable asset (or a group of similar identifiable assets), the fair value of the core goodwill cannot be a substantial part of the total fair value of the gross assets acquired. Thus, information about the value of that core goodwill is unlikely to be material. Moreover, if the fair value of the processes acquired is not significant, the detailed assessment required by paragraphs B8–B12D would be unlikely to conclude that the processes are substantive.

(b) there are some other differences between the accounting required for a business combination and the accounting required for an asset acquisition, including differences relating to deferred tax, contingent consideration, acquisition-related costs, and gains on bargain purchases. Those differences in accounting requirements are not driven by differences between the economics of a business combination and the economics of an asset acquisition. Therefore, the Board did not expect a false positive to result in a loss of information about the economics of a business combination.

BC21AA The concentration test might not identify an asset acquisition that would be identified by the detailed assessment required by paragraphs B8–B12D. That outcome would be a false negative. An entity is required to carry out the detailed assessment in such a case and is expected to reach the same conclusion as if it had not applied the concentration test. Thus, a false negative has no accounting consequences.

BC21AB In finalising the 2018 Amendments, the Board also clarified some aspects of the guidance on a single identifiable asset and on similar identifiable assets (see paragraphs B7B(c)–(f) and B7C).

BC21AC In finalising the 2018 Amendments, the Board did not:

1 Paragraphs BC313–BC318 describe 'core goodwill'. Those paragraphs also note that, because goodwill is measured as a residual, the carrying amount of goodwill includes several other factors as well as core goodwill.

(a) make the concentration test an indicator, rather than determinative. Such a change would have been inconsistent with the objective of reducing the costs of applying IFRS 3 by providing a test that is designed to be simple in some straightforward cases that are easy to explain.

(b) provide further guidance on the term ‘substantially all’ because that term is already used in several IFRS Standards.

