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## **Definition of a business**

### **Issues paper**

#### **Purpose of this paper**

- 1 This paper provides a summary of the IASB tentative decisions on the definition of a business in Exposure Draft *Definition of a Business and Accounting for Previously Held Interests* (the ED); and an overview of the differences between these decisions and the amendments in the Accounting Standards Update *Clarifying the Definition of a Business* (the FASB Amendments).

#### **IASB tentative decisions**

- 2 The IASB received 80 comment letters. The IASB discussed comments received at its meetings in April and June 2017.
- 3 The IASB reached similar tentative decisions on most aspects of the amendments to the definition of a business, except for the screening test. The FASB decided to maintain its original proposal on the screening test and make it mandatory; however as explained in more detail in the paragraphs below, the IASB tentatively decided to make the test optional on a transaction-by-transaction basis.
- 4 The IASB tentative decisions are summarised below:
  - (a) **Screening test** - make the screening test optional on a transaction-by-transaction basis. If the entity elects to use the screening test, it is determinative.
  - (b) **Minimum requirements to be a business** - clarify 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 are required to contribute significantly to the ability to create outputs.
  - (c) **Definition of output** - reaffirm the proposal to amend the definition of 'output' by removing the reference to the ability to reduce costs, and clarifying the meaning of 'other revenues'. The IASB also affirmed its proposal to amend paragraph B8 of the proposal.
  - (d) **Guidance on substantive process** - confirm the guidance proposed in the ED to assess whether a substantive process has been acquired, including the guidance on acquired outsourcing agreements, and to specify in the guidance on substantive processes that difficulties in replacing an acquired workforce may indicate that the workforce performs a substantive process.
  - (e) **Illustrative examples** - reaffirm the proposal to add illustrative examples to help with determining what is considered a business. The IASB also tentatively decided to explore the possibility of illustrating in an example how

the guidance on outsourcing agreements may be applied and clarify the fact patterns of the illustrative examples by separating the assumptions in each example from the conclusions.

- (f) **Goodwill** - to remove from paragraph B12 of IFRS 3 *Business Combinations* the statement that a set of assets and activities in which goodwill is present is presumed to be a business; and 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.
- (g) **Transition** - reaffirm the proposal that an entity would not be required to apply the proposed amendments to transactions that occur before the effective date of the amendments.

## **The screening test**

### *Feedback from respondents*

- 5 The IASB ED proposed to consider a set of activities and assets acquired 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 – referred to as the ‘screening test’.
- 6 Many respondents to the IASB ED, including EFRAG, observed that in some circumstances the proposed screening test may result in inappropriate conclusions, and that certain transactions that are currently (and appropriately) accounted for as business combinations would be classified as asset purchases. They also observed that the screening test might lead to a conclusion that is inconsistent with what would be concluded by assessing whether an acquired process is substantive.
- 7 To address these concerns, the IASB tentatively decided to make the screening test optional on a transaction-by-transaction basis. Thus an entity could on a transaction-by-transaction basis elect to bypass the screening test and assess directly whether a substantive process has been acquired.
- 8 The IASB also tentatively decided to confirm that the screening test is determinative. This means that if an entity has carried out the screening test and concluded that a concentration exists, the entity should treat the transaction as an asset purchase. There is no further assessment that might change that conclusion. If no concentration exists, the entity then should assess whether it has acquired a substantive process.
- 9 Regarding the proposals on how to apply the screening test the IASB decided to:
  - (a) specify that the gross assets considered in the screening test exclude: (i) goodwill resulting from the effects of deferred tax liabilities and (ii) deferred tax assets;
  - (b) clarify that guidance on 'a single asset' for the screening test also applies when one of the acquired assets is a right-of-use asset, as described in IFRS 16 *Leases* (for example leasehold land and the building on it are a single asset for the screening test);
  - (c) clarify that when assessing whether assets are 'similar' for the screening test, an entity should consider the nature of each single asset and the risks associated with managing and creating outputs from the assets; and
  - (d) clarify that the new guidance on what assets may be considered a single asset or a group of similar assets is not intended to modify the existing guidance on similar assets in IFRS Standards.

*IASB rationale to support its tentative decision*

- 10 In the view of the IASB, an option to apply the screening test on a transaction-by-transaction basis would allow entities the flexibility to assess 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.
- 11 The IASB rejected re-characterising the screening test into a mandatory indicator or a rebuttable presumption. 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 screening test in the first place, which is to reduce the cost and complexity of applying the business definition guidance.
- 12 The IASB indicated that if the screening test is made optional, there would be accounting consequences only in cases where the screening test could produce a false positive. The IASB assessed the risk of a false positive as being insignificant because:
  - (a) 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; and
  - (b) the financial impact of a false asset acquisition is likely to be insignificant. Consistent with the reasoning above, the value of any unrecognised goodwill would be small by definition.
- 13 Overall the IASB assessed that the small risk, as identified above, is worth running in light of the cost-saving benefits that the screening test is expected to bring. The IASB also tentatively decided to reword the test as 'can be determinative' as opposed to 'is determinative' to allow for cases where an entity abandons the screening test because a full assessment would indicate that the set acquired is a business.

*The FASB decision*

- 14 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 made in redeliberations, such as the narrowing of the population of what could be considered similar assets.
- 15 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.
- 16 On the application of the screening test, the FASB reached similar decisions to the IASB's tentative decisions in paragraph 9 of this paper.

*EFRAG position in its comment letter on the screening test*

- 17 In its comment letter on the ED, EFRAG expressed concern 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.<sup>1</sup>

- 18 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. 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.
- 19 At the February 2017 meeting, EFRAG TEG and EFRAG CFSS saw no reason to change the EFRAG position in the comment letter that such a screen test be determinative. Some members felt that the rebuttable presumption was perhaps adequate because to some extent they had to emphasise that they should not find themselves with a business combination too easily.

*ASAF discussions in March 2017*

- 20 ASAF members discussed the screening test at the meeting in March 2017 and expressed mixed views on whether the screening test should be mandatory, a rebuttable presumption, or an indicator.
- 21 Some members supported the mandatory screening test proposed by the IASB. Those members observed that the screening test would help preparers in applying the guidance on the definition of a business. These members felt that considering the screening test as an indicator or rebuttable presumption would mean more judgment and could increase complexity because entities would be required to assess whether the presumption should be rebutted.
- 22 Other ASAF members preferred a rebuttable presumption or an indicative screening test. These members were concerned that the screening test was too 'stringent' and that some transactions that are currently accounted for as business combinations would be considered as asset purchases because of the proposed screening test. ASAF members provided examples of such cases.
- 23 ASAF members generally encouraged the IASB to remain converged with the FASB on their respective amendments.

*CMAC discussion in March 2017*

- 24 In March 2017, the IASB Staff discussed the screening test with CMAC members and presented an example (shopping mall – see footnote 1) to illustrate the accounting consequences of the proposed screening test. Similar to other constituents, CMAC members observed that in this example the screening test may not give the right result because the asset acquired has its own customers (ie it generates revenues). Also, it might be that the acquisition of the workforce indicates that the transaction described in the example is a business combination.

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<sup>1</sup> For example, 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.

*EFRAG Secretariat analysis and preliminary views*

- 25 The EFRAG Secretariat are of the view that making the screening test optional on a transaction-by-transaction basis, has the potential to allow entities to select a preferred outcome but that preferred outcome results in an inappropriate conclusion. For example, selecting the screening test to account for a transaction as an asset purchase, when the transaction would be classified as a business combination if the entity performed an assessment of substantive process. This potential could lead to structuring opportunities and reduce comparability of information for users of financial statements. We also note that EFRAG in its comment letter 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 (see paragraph 18 of this paper).
- 26 Furthermore, we do not have evidence to support or explain the tentative conclusion of the IASB (see paragraph 12 and 13) that there is a small risk that having an option will result in inappropriate conclusions because of the few cases where the screening test could produce a false positive. 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.
- 27 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.

**Questions for EFRAG CFSS and EFRAG TEG**

- 28 What are your views on the IASB's tentative decision to make the screening test optional on a transaction-by-transaction basis?
- 29 What suggestions or advice do you have regarding the differences with the FASB Amendments for which the screening test is mandatory?

**IASB tentative decisions on the other proposals in the ED**

***Definition of output***

*IASB and FASB: main differences in the tentative decision*

- 30 The IASB tentatively decided to 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. This decision is not consistent with the FASB Amendments, which state that a set has outputs if there is a continuation of revenue *before and after the transaction*.
- 31 The IASB tentative decision clarifies 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*. However, although the FASB's definition of output does not explain the meaning of "other revenues", the IASB's tentative decision is consistent with the FASB Amendments according to their Basis for Conclusions.

*EFRAG position in its comment letter on the ED*

- 32 EFRAG supported the proposed change to the definition of outputs; however EFRAG was concerned that the term “other revenues” could be interpreted more broadly than intended or interpreted in different ways and asked the IASB to clarify what was intended to be included in “other revenues”. The IASB tentative decision provides this clarification.

**Definition of business and definition of output**

*IASB and FASB: main differences in the tentative decision*

- 33 The IASB tentatively decided to align the definition of a business in Appendix A of IFRS 3 with the revised definition of output in paragraph B7(c) of IFRS 3, because the definition of a business might be perceived as inconsistent with the revised definition of output and thus cause confusion.
- 34 That tentative decision differs from the FASB Amendments, because the FASB did not change the definition of a business. However, the definition of a business in the FASB Amendments includes an explicit reference to the guidance on the definition of a business, and that guidance includes the definition of outputs.

*EFRAG position in its comment letter on the ED*

- 35 EFRAG agreed with the ED definition of business, 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.

**Guidance on acquired outsourcing agreements**

*IASB and FASB: main differences in the tentative decision*

- 36 The IASB tentatively decided to confirm the proposed guidance on acquired outsourcing agreements, including the proposal that an outsourced workforce may perform a substantive process even if the acquired set of assets has no output.
- 37 The IASB’s tentative decision is not consistent with the FASB Amendments because 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.
- 38 The EFRAG Secretariat considers that the impact of this difference is unclear.

*EFRAG position in its comment letter on the ED*

- 39 EFRAG recommended to provide additional guidance to help entities to assess whether an acquired contract gives access to an organised workforce.

**Goodwill**

*IASB and FASB: main differences in the tentative decision*

- 40 The IASB tentatively decided 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.
- 41 That tentative decision 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”.*

- 42 However, the IASB Staff explain that should not cause significant divergence in practice according to the Basis for Conclusions in the FASB Amendments.

*EFRAG position in its comment letter on the ED*

- 43 EFRAG agreed that the presence of more than an insignificant amount of goodwill may indicate that an acquired process is substantive.
- 44 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. Therefore EFRAG recommended to move the goodwill indicator to the Basis for Conclusions.

**Substantive process**

*IASB and FASB: main differences in the tentative decision*

- 45 The IASB tentatively decided to specify in the guidance on substantive processes that difficulties in replacing an acquired workforce may indicate that the workforce performs a substantive process.
- 46 That clarification is not included in the FASB Amendments.

*EFRAG position in its comment letter on the ED*

- 47 EFRAG generally agreed with having two different sets of criteria depending on whether the set of activities and assets has outputs.

**EFRAG Secretariat analysis and preliminary views on the other IASB tentative decisions**

- 48 EFRAG Secretariat’s overall view is that the IASB’s tentative decisions on the other proposals are generally in line with EFRAG’s recommendations in its comment letter.

**Questions for EFRAG CFSS and EFRAG TEG**

- 49 At this stage, do you have any comments on the IASB’s tentative decisions on the other proposals in the ED (other than the screening test) and any potential differences to the FASB Amendments?