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Definition of a Business (Amendments to IFRS 3)

Cover Note

Objective

- 1 The objective of this session is to discuss and approve for recommendation to the EFRAG Board, the draft endorsement advice and invitation to comment on *Definition of a Business (Amendments to IFRS 3)* (the 'Amendments').

Agenda Papers

- 2 In addition to this cover note, agenda papers for this session are:
 - (a) Agenda paper 05-02 – EFRAG's draft letter to the European Commission regarding endorsement of *Definition of a Business (Amendments to IFRS 3)*;
 - (b) Agenda paper 05-03 – Invitation to comment on EFRAG's Assessment on *Definition of a Business (Amendments to IFRS 3)*;
 - (c) Agenda paper 05-04 – Letter from the European Commission requesting endorsement advice – for background only; and
 - (d) Agenda paper 05-05 – *IASB Definition of a Business (Amendments to IFRS 3)* – for background only.

Background

- 3 The IASB issued the Amendments on 22 October 2018.
- 4 The Amendments respond to concerns reported by stakeholders during the Post-implementation Review of IFRS 3 about how to interpret and apply the definition of a business. A summary of the Amendments is included in Appendix 1 of agenda paper 05.02.
- 5 Entities shall apply the Amendments to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2020 and to asset acquisitions that occur on or after the beginning of that period. Earlier application of the Amendments is permitted.
- 6 The Amendments were included in Exposure Draft *ED/2016/1 Definition of a Business and Accounting for Previously Held Interests* that was issued on 28 June 2016. EFRAG issued its comment letter on that Exposure Draft on 9 November 2016, generally supporting the initiative but raising some concerns.
- 7 The EFRAG Secretariat notes that the final Amendments are largely in line with EFRAG's views and recommendations in its Comment Letter. EFRAG TEG generally supported the decisions of the IASB on the almost final Amendments when these were discussed at the EFRAG TEG meeting in June 2018 ([EFRAG TEG meeting 13-14 June](#)

[2018, agenda paper 07-01](#)). EFRAG TEG also noted that the optional concentration test was in line with EFRAG's recommendation, namely making it a rebuttable presumption and not a mandatory test while introducing simplification and relief for more obvious transactions. The relevant extract from the minutes of that meeting is included in the Appendix.

- 8 The European Commission issued a letter requesting advice on the endorsement of the Amendments on 12 November 2018 (agenda paper 05-04). The letter did not identify specific matters to be assessed and asked that EFRAG supports its advice by an impact analysis, including a cost-benefit analysis and an analysis of broader economic impacts.

Draft endorsement advice

- 9 The EFRAG Secretariat has prepared a draft endorsement advice and an accompanying invitation to comment (in agenda papers 05-02 and 05-03, respectively).
- 10 The EFRAG Secretariat has tentatively concluded that the Amendments:
 - (a) meet the qualitative characteristics required to support economic decisions and the assessment of stewardship and raise no issues regarding prudent accounting; and
 - (b) are conducive to the European public good.

Question for EFRAG TEG

- 11 Does EFRAG TEG agree to recommend the draft endorsement advice (contained in agenda paper 05-02) and the invitation to comment (contained in agenda paper 05-03) for consideration by the EFRAG Board?

Appendix: Extract from the Minutes of the EFRAG TEG meeting on 13-14 June 2018

- 1 The extract below from pages 11 to 13 of the minutes of the EFRAG TEG June 2018 meeting is the section relevant to the discussion of the almost final Amendments ([EFRAG TEG meeting 13-14 June 2018, agenda paper 07-01](#)):

Screening Test

- 2 Nicklas Grip stated that he supported the suggestion of the screening test not being made mandatory. If the screening test focused on assets rather than earnings or equity, this could create a potential false positive. Discussions would continue to be needed with regard to financial sector transactions in particular.
- 3 Geert Ewalts agreed that the screening test ought not to be mandatory. In the financial sector and also for insurance companies, he typically saw that liabilities would be a substantial part of an acquisition. There were examples of false positives, and he did not know if these had been considered at all.
- 4 Cédric Tonnerre felt satisfied with the IASB's suggestion, which was in line with what had been requested in the comment letter on the Exposure Draft (the ED issued by French Standard Setter. He would also support a rebuttable presumption. Overall, he was happy with the conclusions of the staff and with the suggested standard.
- 5 Andrew Watchman noted that while the IASB had suggested the risk of false positives was small, EFRAG TEG members had already frequently referred to such false positives. If there were a number of transactions that could yield false positives, it would seem that there was an accounting arbitrage at work.
- 6 Andrew Spooner asked if there were any plans with regard to disclosure. Given that this was accounting policy choice, he further asked if there would be any obligation on an entity to disclose that it was carrying out the screening tests. Andrew Watchman replied that the EFRAG staff could check this.
- 7 Heinz Hense noted that a false positive could emerge where there was a single asset business. Such business models did exist, hence such concerns being raised. From a policy standpoint, there was also the question of what a preparer might be able to do in order to reap an advantage from this situation.
- 8 Tommaso Fabi stated that the issue was to do with recognition of goodwill against the deferred tax liabilities arising from the fair value of the asset in a business combination. British colleagues had studied this point substantially. Specifically on the IASB's decision regarding the screening test, he understood this compromise. He was also wondering whether the screening test was an accounting policy choice or a cherry-picking approach.
- 9 Anthony Appleton stated that he supported the proposal, which was mostly in line with what he had suggested. Whilst there may be false positives, he would tend to agree with the IASB's assessment of the matter.
- 10 Jed Wrigley stated that although he was not a preparer, it appeared the proposal indicated that where something was obviously an asset purchase, it was an asset purchase; and where it was not obvious at all, management could get to the answer they wanted.
- 11 Sven Morich added that he would need to see the final text, but the proposal seemed to be much in line with the direction that had been discussed, namely making this a rebuttable presumption and not a mandatory test while introducing simplification and relief for certain simple or obvious transactions.
- 12 Andrew Watchman agreed with Sven Morich. The idea was supposed to be a simplification and a relatively straightforward way of assessing transactions which were

obvious but not so obvious; there was a trade-off between providing relief and the risk of false positives.

- 13 Ana Cortez agreed with Jed Wrigley, further noting that false positives would exist in areas where there were heavy assets such as real estate, oil, energy, mining, or land. The question was what to do with these and what the proposal would be to deal with them; she was not yet clear about this. Andrew Watchman noted that EFRAG had not yet reached the proposal stage; it would soon develop a draft and then the final endorsement advice. During this process, one would have to keep in mind the question of whether simplification would justify the issue of comparability and false positives.
- 14 Günther Gebhardt felt that the discussion was taking place because there was a cliff edge effect in changing from a business combination to an asset acquisition. Removing this cliff-edge effect was one way to remove the problem. The problem was in a sense having a value in use valuation rather than a fair value valuation.
- 15 Anthony Appleton stated that the majority of cases this proposal was trying to deal with involved a corporate wrapper called a business. There was a cliff-edge, but at that cliff-edge, the issue was if one did or did not recognise deferred tax liability. Recognising this deferred tax liability on a business acquisition created goodwill that was non-existent. He reiterated that the suggested position was broadly what he had wanted.
- 16 Sven Morich reiterated that there were concerns around false positives coming from the screening test or from changes in the qualitative assessment. There might be an additional risk from further amendments, but he could not see why the screening test could lead to any further risk for business combination assessments. Andrew Watchman stated that in the ED, the screening test had been proposed to be mandatory, and so there had been a concern that this could give a different outcome from the detailed assessment. This was still the case with an optional screening test, but then the outcome would also be optional. Tommaso Fabi added that he had questioned for example if accounting would be all that different in the particular fact patterns where these false positives might emerge.
- 17 Andrew Watchman summarised that EFRAG TEG members had acknowledged the proposal as one way of addressing concerns EFRAG had raised in its comment letter. The matter would be returned to at the draft endorsement advice stage.

Further Amendments

- 18 Nicklas Grip noted that when reading the substantive process on life insurance and the mortgage business, this normally created extreme output based on little input, with assets and liabilities doing the work. This was usually a passive business. However, reading paragraphs 64 and 65 of the issues paper he observed that the IASB seemed to take care of this. He also really liked that contracts on outsourcing and so on could also be included in the substantive process.
- 19 Ana Cortez noted that paragraph 67 of the issues paper on acquiring contracts stated it 'should include an organised workforce'. She asked if this was IASB's view, because paragraph 69 regarding the substantive processes contained an apparent contradiction. She gave the example of a bank that had an internal collection business that was then sold to a joint venture, and the subsequent issues associated with the transferral of the workforce. Consequently, she was wondering what the role of the workforce would be in an acquired contract.
- 20 Emmanuelle Guyomard stated that she had the same concern about outsourcing contracts, which were more and more frequent in business combinations and divestment. She asked if the IASB would define some criteria to allow assessment of where outsourcing contracts allowed access to a workforce. For example, were contracts needed that were secured for a certain period of time? Andrew Watchman replied that he expected the wording of the draft to explain whether an acquired contract

could give access to an organised workforce. This should be an area of specific focus in the response.

Transition, Developing the Draft Endorsement Advice

- 21 Anthony Appleton asked about the transition date. Andrew Watchman replied that this was prospective from a particular date.
- 22 Andrew Spooner noted that one would be applying something earlier, but then within that one would have certain choices. It was unclear whether these choices would be much different from if one had not applied it earlier. Indeed, it was unclear what this meant. This came back to his earlier point about disclosure of the screening test. Presumably applying earlier would have to be disclosed, but he was unsure if application of the screening test also needed to be disclosed. Andrew Watchman stated that very close attention would be paid to the transition in developing the draft endorsement advice.