EFRAG's Letter to the European Commission regarding endorsement of *Definition of a Business (Amendments to IFRS 3)*

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European Commission
1049 Brussels

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Dear Mr Guersent

Endorsement of *Definition of a Business (Amendments to IFRS 3)*

Based on the requirements of Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards, EFRAG is pleased to provide its opinion on *Definition of a Business (Amendments to IFRS 3)* ('the Amendments'), which were issued by the IASB on 22 October 2018. 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 provided its comment letter on that Exposure Draft on 9 November 2016. The topic of accounting for previously held interests was finalised and included in *Annual Improvements to IFRS Standards 2015-2017 Cycle* issued in 2017.

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, with the objective to clarify the definition and assist entities to determine whether a transaction should be accounted for as a business combination or as an asset acquisition.

The Amendments shall be applied to transactions 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. If entities apply the Amendments earlier, they shall disclose that fact. A description is included in Appendix 1 to this letter.

In order to provide our endorsement advice as you have requested, we have first assessed whether the Amendments would meet the technical criteria for endorsement, in other words whether the Amendments would provide relevant, reliable, comparable and understandable information required to support economic decisions and the assessment of stewardship, lead to prudent accounting and are not contrary to the true and fair view principle. We have then assessed whether the Amendments would be conducive to the European public good. We provide our conclusions below.

EFRAG has carried out an evaluation of the Amendments. As part of that process, EFRAG issued its initial assessment for public comment and, when finalising its advice and the content of this letter, took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

Do the Amendments meet the IAS Regulation technical endorsement criteria?

Based on the above reasoning, EFRAG has concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, and raise no issues regarding prudent accounting. EFRAG has also assessed that the Amendments do not create any distortion in their interaction with other IFRS Standards and that all necessary disclosures are required. Therefore, EFRAG has concluded that the Amendments are not contrary to the true and fair view principle. EFRAG's reasoning is explained in Appendix 2 to this letter.

Are the Amendments conducive to the European public good?

EFRAG has assessed that the Amendments would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified that the Amendments could have any adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that endorsing the Amendments is conducive to the European public good. EFRAG's reasoning is explained in Appendix 3 to this letter.

Our advice to the European Commission

As explained above, we have concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, raise no issues regarding prudent accounting, and are not contrary to the true and fair view principle. We have also concluded that the Amendments are conducive to the European public good. Therefore, we recommend the Amendments for endorsement.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix 1: Understanding the changes brought about by the Amendments

Background of the Amendments

1 On 22 October 2018 the IASB issued narrow-scope amendments to IFRS 3 *Business combinations* (the 'Amendments'), to clarify the definition of a business.

2 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. The topic of accounting for previously held interests was finalised and included in *Annual Improvements to IFRS Standards 2015-2017 Cycle* issued in 2017.

3 The IASB developed the Amendments after considering feedback from the Post-implementation Review ('PIR') of IFRS 3 *Business Combinations*, completed in 2015, that identified challenges related to interpreting and applying the definition of a business. In particular, many respondents to the PIR noted that there was little or no guidance to identify situations where an acquired set of activities and assets is not a business resulting in inconsistent practices and acquisitions, more akin to an asset purchase, being recognised as a business combination.

The issue and how it has been addressed

4 The Amendments provide clarifications and additional guidance to address the concerns and difficulties highlighted by the PIR of IFRS 3.

5 The Amendments are intended to assist entities to determine whether a transaction involving an acquired set of activities and assets should be accounted for as a business combination or an asset acquisition.

6 The IASB acknowledged that the pre-existing IASB and FASB definitions were the same but were not applied consistently in practice. Although the IASB and FASB have addressed the application challenges slightly differently the IASB has assessed that the overall effect of both changes taken together will be greater consistency in the application of the definition of a business across entities applying US GAAP and IFRS Standards.

7 A summary of the Amendments is provided below.

What has changed?

Minimum requirements to be a business

8 The Amendments 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 significantly contribute to the ability to create outputs. They also clarify that a set of activities and assets can qualify as a business without including all of the inputs and processes needed to create outputs, or including the outputs themselves, by replacing the term 'ability to create outputs' with 'ability to contribute to the creation of outputs'.

Market participant's ability to replace missing elements

9 It is no longer necessary to assess whether market participants are capable of replacing any missing inputs or processes (for example by integrating the acquired activities and assets) and continuing to produce outputs. The Amendments focus on whether acquired inputs and acquired substantive processes, together, significantly contribute to the ability to create outputs.

Assessing whether an acquired process is substantive

10 The Amendments provide guidance and illustrative examples to help entities assess whether an acquired process is a substantive process. The guidance requires more persuasive evidence when the acquired set of activities and assets has no outputs as the existence of outputs already provides evidence that the acquired set of activities and assets is a business.

11 When there are outputs at the acquisition date (i.e. revenue is generated) an acquired process is substantive in **either** of the following cases:

(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

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

12 If there are no outputs at the acquisition date, an acquired process is considered substantive if **both** the following criteria are met:

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

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

13 The Amendments note that an acquired contract (such as an outsourced asset management arrangement) is not a substantive process, in order to clarify that a contract that provides a continuing revenue stream (e.g. a lease contract) is not itself a process. However, the Amendments also inform that an acquired contract can give access to an organised workforce which, in turn, performs a substantive process that the entity has acquired.

Narrowed definition of outputs

14 The Amendments narrow the definition of outputs by focusing on goods and services provided to customers, investment returns and other income from ordinary activities, and by removing the reference to returns in the form of lower costs and other economic benefits directly to investors or other owners, members or participants. The definition of a business has also been amended to make it consistent with the narrowed definition of outputs.

Concentration test

15 An optional concentration test has been added that permits a simplified assessment of whether an acquired set of activities and assets is not a business. The test is designed to reduce costs and complexity by avoiding the need for a detailed assessment in some cases. 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. Entities may elect whether or not to apply the concentration test on a transaction-by-transaction basis. If the test is not met, or if an entity elects not to apply it, an entity would be required to perform a detailed assessment.

16 The focus of the concentration test is on gross assets, rather than net assets, mainly because the existence of associated debt or other liabilities (i.e. how the acquisition was financed) should not affect the assessment of whether what is acquired is a business. For similar reasons, the concentration test also excludes cash and cash

equivalents acquired, as well as deferred tax assets and goodwill resulting from the effects of deferred tax liabilities.

17 Overall, the concentration test is expected to lead to fewer transactions being accounted for as business combinations. This will respond to concerns raised by preparers in the PIR of IFRS 3.

When do the Amendments become effective?

18 Entities shall apply the Amendments prospectively 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. If an entity applies the Amendments for an earlier period, it shall disclose that fact.

Appendix 2: EFRAG's technical assessment on the Amendments against the endorsement criteria

Does the accounting that results from the application of the Amendments meet the technical criteria for endorsement in the European Union?

1 EFRAG has considered whether the Amendments meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002 (the 'IAS Regulation'), in other words that the Amendments:

(a) are not contrary to the principle set out in Article 4 (3) of Council Directive 2013/34/EU (the 'Accounting Directive'); and

(b) meet the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

2 Article 4(3) of the Accounting Directive provides that:

The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.

3 The IAS Regulation further clarifies that *'to adopt an international accounting standard for application in the Community, it is necessary firstly that it meets the basic requirement of the aforementioned Council Directives, that is to say that its application results in a true and fair view of the financial position and performance of an enterprise – this principle being considered in the light of the said Council Directives without implying a strict conformity with each and every provision of those Directives'* (Recital 9 of the IAS Regulation).

4 EFRAG's assessment as to whether the Amendments would not be contrary to the true and fair view principle has been performed against the European legal background summarised above.

5 In its assessment, EFRAG has considered the Amendments from the perspectives of both usefulness for decision-making and assessing the stewardship of management. EFRAG has concluded that the information resulting from the application of the Amendments is appropriate both for making decisions and assessing the stewardship of management.

6 As mentioned in Appendix 1, the Amendments are intended to help entities to determine whether an acquired set of activities and assets (also referred to as an acquired set) should be accounted for as a business combination or an asset acquisition. Overall, the Amendments do not substantially change the underlying principle in IFRS 3 of what comprises a business. Although the Amendments do not introduce new recognition or measurement requirements, they affect the accounting because some transactions are likely to be treated differently to how they are treated now.

7 The Amendments address the following aspects of the definition of a business:

(a) Minimum requirements to be a business;

(b) Market participant's ability to replace missing elements;

(c) Guidance on assessing whether an acquired process is substantive;

(d) Narrowed definition of outputs; and

(e) Optional concentration test.

8 EFRAG assessed that the amendments in paragraphs 7(a), 7(b) and 7(d) are straightforward and not controversial as they do not raise any significant issues or change existing IFRS 3 requirements in any significant way. Overall, the expectation if anything, from these clarifications and minor changes to the definition, is that fewer transactions will qualify as a business combination. Therefore, EFRAG has not further assessed these specific amendments against the endorsement criteria.

9 EFRAG assessed the amendments in paragraphs 7(c) (assessing whether an acquired process is substantive) and 7(e) (optional concentration test) separately in paragraphs 10 to 35 below.

Guidance on assessing whether an acquired process is substantive

Understandability, relevance, reliability and comparability

10 EFRAG observes that the guidance provided by the Amendments is intended to help entities determine whether an acquired process is substantive.

11 EFRAG assesses that the guidance will increase relevance of information for users by helping preparers to assess what has been acquired and specifically whether it contains a substantive process, which is an essential element for an acquired set be considered a business. EFRAG observes that the guidance will reduce complexity and therefore improve understandability of what is considered a substantive process. The guidance will also increase comparability of information by clarifying the existing definition and consequently result in more consistent application when assessing whether a process is substantive.

12 The Amendments provide a different set of assessment criteria depending on whether the acquired set has outputs or not and require more persuasive evidence in case there are no outputs. EFRAG considers the different criteria to be an appropriate basis to differentiate between acquired sets with and without outputs. In particular, EFRAG observes that acquisitions without outputs have proved to be more problematic in practice and have raised interpretation issues when deciding whether or not they comprise a business. EFRAG also considers that if outputs are not present, an organised workforce is relevant to determine whether a process is substantive because an input on its own cannot create outputs and would need a capable and skilled workforce to generate outputs.

13 Furthermore, EFRAG considers that allowing an acquired contract, such as an outsourcing service arrangement, to be a replacement to a workforce will enhance comparability of information as it will enable transactions with similar characteristics to be accounted for in a similar way. The fact that an entity has chosen to outsource its workforce (or part thereof) should not lead to a different conclusion as the activities under an outsourcing arrangement may not be significantly different to the activities performed by employees of the entity.

14 Finally, although this is considered to mainly impact comparability of information, EFRAG assesses that overall the more comprehensive guidance on assessing of whether an acquired process is substantive will lead to information relating to acquired sets of activities and assets that is more relevant and reliable because it represents more faithfully what it is expected to represent.

Optional concentration test

Relevance

15 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

16 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

17 EFRAG acknowledges that, in theory, the concentration test might sometimes identify an acquired set as an asset acquisition when the more detailed assessment required by IFRS 3 would identify it as a business. If an entity decides to apply the test, this outcome would be a so-called 'false positive' outcome as an entity would recognise an asset acquisition instead of a business combination (which is accounted for differently under IFRS 3). However, EFRAG observes that the test is designed to keep these cases to a minimum. EFRAG therefore assesses that the likelihood of 'false positives' would not have a significant impact on relevance of information.

18 EFRAG's overall assessment is that the concentration test will not result in less relevant information being provided and therefore satisfies the relevance criterion.

Reliability

19 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

20 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

21 EFRAG observes that 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 assets. The Amendments provide guidance on a single identifiable asset and on similar identifiable assets to help entities make a decision and reach the appropriate conclusion that represents faithfully what the acquired set purports to represent.

22 EFRAG assesses that the calculation of the fair value of the gross assets acquired should not affect reliability of information in any significant way, given that the focus of the concentration test is on a single asset (or group of similar assets). In other words, the test is intended for simple acquisitions that involve only a single asset or a few assets and could be considered as being obvious asset acquisitions. EFRAG also observes the Amendments clarify that the fair value of the gross assets acquired may normally be determined by reference to the fair value of the consideration transferred, and therefore provide relief from detailed calculations. Therefore, the Amendments do not introduce any new reliability concerns.

23 Finally, EFRAG assesses that making the test optional and therefore non-determinative, enables entities to assess whether they have acquired a substantive process, when such an assessment would result in a conclusion that more faithfully represents the economics of the acquired set.

24 EFRAG's overall assessment is that the concentration test would result in the provision of reliable information and therefore satisfies the reliability criterion.

Comparability

25 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

26 EFRAG has considered whether the Amendments result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

27 As previously mentioned, the concentration test provides a simplified assessment of whether an acquired set is not a business given that IFRS 3 provides little or no guidance in this respect. EFRAG observes that this lack of guidance has resulted in diversity in practice. The concentration test will reduce this diversity and result in more consistent determinations when deciding whether an acquired set is or is not a business. The test is also expected to result in a conclusion that more faithfully represents the economics of the acquisition.

28 EFRAG acknowledges that the optional nature of the concentration test could result in less comparability. However, entities are expected to make similar choices in relation to the test because it provides a simpler and less costly alternative. Entities are likely to use it when a single asset represents a significant part of the consideration paid for the acquired set. For transactions that are clearly asset acquisitions, the concentration test will result in an increase in comparability because entities will not have to make subjective judgements about whether processes are substantive or not.

29 As mentioned in paragraph 17, EFRAG acknowledges that, in theory, the concentration test might sometimes result in an acquired set being considered an asset acquisition when under the more detailed assessment it would be a business. However, consistent with EFRAG's assessment in paragraph 17, EFRAG observes that such cases would be minimal and thus would not have a significant impact on comparability.

30 EFRAG's overall assessment is that the concentration test satisfies the comparability criterion.

Understandability

31 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.

32 Although there are a number of aspects related to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

33 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendments is understandable, is whether that information will be unduly complex.

34 EFRAG observes that the concentration test does not introduce any new concepts that would create complexity and impair understandability. Furthermore, in view of the fact that the concentration test will be applied by preparers for determining whether an acquired set is not a business, EFRAG believes that it does not affect the complexity of any of the financial information provided.

35 EFRAG's overall assessment is that the concentration test does not introduce any new complexity and therefore satisfies the understandability criterion in all material respects.

Prudence

36 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated.

37 As mentioned in paragraph 6, the Amendments do not substantially change the existing requirements. Furthermore, although they affect the accounting because some transactions will be treated differently than what they are treated today, they do not introduce new recognition and measurement requirements. EFRAG therefore assesses that they raise no issues in relation to prudence as defined above.

True and fair view principle

38 A Standard will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS Standards, it:

(a) does not lead to unavoidable distortions or significant omissions in the representation of that entity's assets, liabilities, financial position and profit or loss; and

(b) includes all disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss.

39 EFRAG has assessed that the Amendments do not create any negative interactions with other IFRS Standards. On the contrary, clarifying the definition of a business and providing a framework to help preparers in the decision-making process will reduce complexity and ensure more consistent application.

40 Accordingly, EFRAG has assessed that the Amendments do not lead to unavoidable distortions or significant omissions and therefore do not impede financial statements from providing a true and fair view.

41 As a result, EFRAG concludes that the application of the Amendments would not lead to information that would be contrary to the true and fair view principle.

Conclusion

42 Accordingly, for the reasons set out above, EFRAG's assessment is that the Amendments meet the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether the Amendments are conducive to the European public good

Introduction

1 EFRAG considered whether it would be conducive to the European public good to endorse the Amendments. In addition to its assessment included in Appendix 2, EFRAG has considered a number of issues in order to identify any potential negative effects for the European economy on the application of the Amendments. In doing this, EFRAG considered:

(a) Whether the Amendments improve financial reporting. This requires a comparison of the Amendments with the existing requirements and how they fit into IFRS Standards as a whole;

(b) The costs and benefits associated with the Amendments; and

(c) Whether the Amendments could have an adverse effect to the European economy, including financial stability and economic growth.

2 These assessments allow EFRAG to draw a conclusion as to whether the Amendments are likely to be conducive to the European public good. If the assessment concludes there is a net benefit, the Amendments will be conducive to the objectives of the IAS Regulation.

EFRAG's evaluation of whether the Amendments are likely to improve the quality of financial reporting

3 As explained in Appendix 1, many stakeholders expressed concerns about how to interpret and apply the definition of a business.

4 EFRAG assesses that the Amendments will provide preparers with a more comprehensive framework to help in the assessment process and result in more consistent application of the definition of a business. The clarifications and guidance provided by the Amendments are expected to improve the understanding of the definition of a business, and result in a conclusion that more faithfully represents the economics of the acquisition.

5 EFRAG has therefore concluded that the Amendments are likely to improve the quality of financial reporting.

EFRAG's ~~initial~~ analysis of the costs and benefits of the Amendments

6 EFRAG first considered the extent of the work needed to apply the Amendments. For some IFRS Standards or IFRS Interpretations, it might be necessary to carry out some extensive work, in order to understand fully the cost and benefit implications of the IFRS Standard or IFRS Interpretation being assessed. However, in the case of the Amendments, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work.

7 Therefore, as explained more fully in the main sections of this Appendix, the approach that EFRAG has adopted has been to carry out an initial assessment of the likely costs and benefits of implementing the Amendments in the EU, to consult on the results of those initial assessments, and to finalise those assessments in light of the comments received.

Cost for preparers and users

8 EFRAG has carried out an assessment of the cost implications for preparers and users resulting from the Amendments.

9 EFRAG's ~~initial~~ assessment is that any one-off costs for preparers are expected to be limited to familiarisation with the Amendments and updating any internal guidance and relevant processes. This is because the Amendments:

(a) do not substantially change the existing definition of a business;

(b) do not introduce new recognition or measurement requirements (although they might change the way some transactions are accounted for); and

(c) are applicable prospectively and therefore entities are not required to revisit previously made assessments.

10 Furthermore, the clarified definition and the concentration test have the potential to facilitate the assessment by preparers of whether an acquired set is a business or not. Specifically, EFRAG assesses that the use of the concentration test is likely to reduce the cost and effort for preparers when a transaction clearly is not a business.

11 Overall, EFRAG's assessment is that the Amendments will not result in significant one-off costs for preparers, are likely to reduce the ongoing costs for preparers and are likely to be cost neutral for users.

Benefits for preparers and users

12 EFRAG has carried out an assessment of the benefits for preparers and users resulting from the Amendments.

13 EFRAG's assessment is that:

(a) preparers are likely to benefit from the Amendments, as the clarified definition and revised guidance have the potential to facilitate the assessment of whether an acquired set is a business or not; and

(b) users are likely to benefit from the Amendments as they have the potential to lead to more consistent classification of transactions as assets acquisitions or business combinations, and the information resulting from them will therefore increase comparability between entities and enhance users' analysis.

Conclusion on the costs and benefits of the Amendments

14 EFRAG's overall assessment is that the overall benefits of clarifying the definition of a business and permitting a simplified assessment of the nature of the transaction, are likely to outweigh costs associated with the implementation of the Amendments.

Conclusion

15 EFRAG believes that the Amendments will generally bring improved financial reporting when compared to previous guidance. As such, their endorsement is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship.

16 EFRAG has not identified that the Amendments could have any adverse effect to the European economy, including financial stability and economic growth.

17 Furthermore, EFRAG has not identified any other factors that would mean endorsement of the Amendments is not conducive to the European public good.

18 Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendments, EFRAG assesses that endorsing the Amendments is conducive to the European public good.