European Securities and Markets Authority

The Chair

Date: 12 October 2016
ESMA/2016/1466

Mr Andrew Watchman
European Financial Reporting Advisory Group (EFRAG)
35 Square de Meeûs
1000 Brussels,
Belgium

Ref: The IASB's Exposure Draft *Definition of a Business and Accounting for Previously Held Interests*

Dear Mr Watchman,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the EFRAG's due process. ESMA has considered EFRAG's draft comment letter to the IASB's Exposure Draft (ED) *Definition of a Business and Accounting for Previously Held Interests*. We are pleased to provide you with the following comments with the aim of improving the enforceability of IFRSs and the transparency and decision usefulness of financial statements.

ESMA welcomes the proposed amendments to the definition of a business as it has identified a number of implementation issues as part of its contribution to the post-implementation review of IFRS 3 *Business Combinations*. However, like EFRAG, ESMA encourages the IASB to further develop the proposed two-step approach and clarify how the assessment of concentration of fair value (screening test) should be carried out, notably the assessment whether a group of assets is sufficiently homogeneous to be considered a group of similar assets.

Like EFRAG, ESMA welcomes the fact that the IASB's and the FASB's proposals are substantially converged. In order to ensure that convergence is also achieved in practice, the differences in the wording of the standards should not be used as a reason for divergent outcomes.

Finally, like EFRAG, ESMA agrees with the proposed amendments regarding acquisitions of interests in businesses that are joint operations. However, ESMA notes that this amendment captures only two of the practical issues related to re-measurement of the previously held interest in business combinations. In this context ESMA is of the view that a more comprehensive project considering acquisition and disposals of interest in businesses should be considered in the future in order to minimise structuring opportunities.

Our detailed comments on the ED are set out in Appendix I to this letter. Please do not hesitate to contact us should you wish to discuss all or any of the issues we have raised.

Yours sincerely,

Steven Maijoor

Appendix I – ESMA's detailed answers to the questions in the ED

Question 1

The Board is proposing to amend IFRS 3 to clarify the guidance on the definition of a business (see paragraphs B7–B12C and BC5–BC31). Do you agree with these proposed amendments to IFRS 3?

In particular, do you agree with the Board's conclusion that if substantially all the fair value of the gross assets acquired (ie the identifiable assets and non-identifiable assets) is concentrated in a single identifiable asset or group of similar identifiable assets, then the set of activities and assets is not a business (see paragraphs B11A–B11C)?

Why or why not? If not, what alternative would you propose, if any, and why.

1. ESMA welcomes the proposals of the Board to clarify the guidance on the definition of a business. In its review of accounting practices of IFRS 3,[1] ESMA noted that the assessment whether an acquisition constitutes a business requires significant use of judgment, in particular in specific industries (such as the real estate and pharmaceutical sectors). Consequently, ESMA urged the IASB to improve and amplify the guidance on the definition of a business.

<u>Two-steps approach</u>

2. ESMA welcomes the two-step approach (i.e. assessment of concentration of fair value and evaluating whether an acquired process is substantive) as proposed in paragraph B8A of the ED. However, we believe that those steps would benefit from further consideration and development.

3. Whereas ESMA agrees with the proposed approach to determine whether the transaction is primarily a purchase of a single asset or a group of assets by assessing whether the fair value of the gross assets acquired is concentrated in a single asset or in a group of similar assets (the screening test), we are of the view that further clarification in its application is desirable. We propose that the final standard includes a principle which specifies when a group of similar assets is sufficiently homogeneous to constitute a group of similar identifiable assets. Such principle could help to understand whether the list of items in paragraph B11C of the ED represents an exhaustive list or rather an indicative list of examples.

4. ESMA welcomes the guidance in paragraph B11C of the ED. At the same time, we urge the IASB to further explain the interaction with the guidance on similar assets in paragraph 36 of IAS 38 *Intangible Assets* (e.g. guidance on recognition of an intangible asset acquired

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[1] Report, Review on the application of accounting requirements for business combinations in IFRS Financial Statements, ESMA, June 2014, ESMA/2014/643

in a business combination together with the related item). Furthermore, ESMA notes that the term 'class' is already defined for measurement purposes in paragraph 37 of IAS 16 *Property, Plant and Equipment* and paragraph 73 of IAS 38, as well as for disclosure purposes in paragraph 6 of IFRS 7 *Financial Instruments: Disclosures*, paragraph 73 of IAS 16 and paragraph 119 of IAS 38. Therefore, the final standard should clarify whether these definitions of classes apply also in the context of assessment of concentration of fair value.

Insignificant amount of goodwill

5. ESMA agrees with the IASB's proposal that the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive and the set of activities and assets is a business. However, ESMA proposes that the IASB clarifies whether there may be situations when presence of more than an insignificant amount of goodwill does not indicate that the set of activities and assets is a business. ESMA suggests that, in this context, the IASB provides additional clarity to fact patterns when goodwill is 'created' by deferred tax. An example could be the acquisition of a shell company owning investment property. ESMA recommends that the IASB in its proposals illustrates for such fact patterns whether it believes that the acquired processes are substantive.

6. Furthermore, ESMA also suggests that the IASB explicitly states in the basis for conclusions that the intent is only to provide another indicator to assist an entity and not to create an additional step in the analysis. Such statement would also align the guidance with the FASB ED as such statement is included in paragraph BC 33 of the FASB ED.

Examples

7. While ESMA welcomes the examples that illustrate the application of the proposed guidance, ESMA considers that it would be helpful to provide additional examples focused more on the areas that require a high level of judgment (e.g. cases of asset acquisitions when organized workforce is acquired). ESMA also encourages to further align the descriptions and conclusions of all examples provided in the IASB and FASB EDs in order to avoid any different interpretations for the same cases. More specifically, ESMA has the following comments on the examples included in the ED:

8. As regards example C (acquisition of a television station), paragraph IE82 of the ED states that the set of activities and assets does not have outputs. It is not clear from the example whether the set of activities and assets acquired generated revenue at the acquisition date (as required by paragraph B12B of the EC), so it may be clarified whether the assertion that the set of activities and assets does not have outputs at the acquisition date is an assumption in this example.

9. Concerning example D (acquisition of a factory that is temporarily closed-down), ESMA suggests that the reasoning in paragraph IE 85 of the ED is articulated more clearly, notably with regards to the process acquired.

10. Regarding example I (acquisition of investment properties), paragraph IE101 of the ED states that the acquired organized workforce is critical to the ability to continue producing outputs. ESMA considers that it would be helpful to further explain the importance of the fact of the employees being transferred in the context of this activity (leasing of buildings).

Other comments

11. ESMA considers also that it would be beneficial if the term 'other revenues' in paragraph B7(c) of the ED was explained and relevant examples were presented. Furthermore, ESMA suggests that the Board amends the definition of a business in Appendix A to IFRS 3 in line with the proposed amendments to paragraph B7 of the ED.

Question 2

The Board and the FASB reached substantially converged tentative conclusions on how to clarify and amend the definition of a business. However, the wording of the Board's proposals is not fully aligned with the FASB's proposals.

Do you have any comments regarding the differences in the proposals, including any differences in practice that could emerge as a result of the different wording?

12. ESMA highlights the need of maintaining convergence between the definition of a business in IFRS 3 and in the US standard. Consequently, ESMA welcomes the unambiguous statement in the ED that the Board and the FASB reached substantially converged tentative conclusions on how to clarify and amend the definition of a business. However, the wordings of the proposed amendments are not fully aligned (e.g. in the IASB's and the FASB's EDs, the order and wording of the list of assets that shall not be combined into a single identifiable asset or considered a group of identifiable assets differs). Even though ESMA has not identified any specific differences in practice that could emerge, the variances in wording might lead to confusion as to whether the Boards intended to achieve different outcomes in particular aspects.

Question 3

To address diversity of practice regarding acquisitions of interests in businesses that are joint operations, the Board is proposing to add paragraph 42A to IFRS 3 and amend paragraph B33C of IFRS 11 to clarify that:

> *(a) on obtaining control, an entity should re-measure previously held interests in the assets and liabilities of the joint operation in the manner described in paragraph 42 of IFRS 3; and*

(b) on obtaining joint control, an entity should not re-measure previously held interests in the assets and liabilities of the joint operation.

Do you agree with these proposed amendments to IFRS 3 and IFRS 11? If not, what alternative would you propose, if any, and why?

Re-measurement of previously held interest

13. ESMA agrees with these proposed amendments on re-measurement, as they reflect the underlying principles of IFRS 3 and IFRS 11 *Joint Arrangements*.

14. To increase enforceability of the standard, ESMA encourages the IASB to clarify directly in paragraph 42A of IFRS 3, rather than only in the Basis for Conclusions that re-measurement of the previously held interest in the joint operation means re-measurement of the share in the individual assets and liabilities. This represents a difference to the approach in paragraph 42 that describes the re-measurement of the equity interest in the investee. Furthermore, the Basis for Conclusions could clearly identify that in such case, the fair value of assets and liabilities represents the respective share of the fair value of assets and liabilities as measured in the purchase-price allocation.

15. ESMA notes that this amendment captures only two of the practical issues related to re-measurement of the previously held interest in business combinations. In this context ESMA suggests that the IASB comprehensively assesses the requirements to re-measure previously held interests. Such comprehensive approach might identify further need for clarification, notably in cases that might be more prevalent in practice than the individual issues currently being addressed. Furthermore, we encourage the Board to consider the interaction of definition of a business and its legal form as this is of particular relevance when accounting for acquisitions and disposals of interests in associates given that IAS 28 *Investments in Associates and Joint Ventures* defines an associate referring to a legal entity rather than to a business.

Business combination achieved in stages

16. ESMA notes that the heading above paragraph 41 of IFRS 3 refers to 'business combination achieved in stages'. However, IFRS 3 defines a business combination as a transaction in which an acquirer obtains control of one or more businesses. Consequently, as control is only obtained at one specific point in time, we suggest that the IASB replaces the heading to indicate that paragraph 41-42 relate to accounting for previously held interests. Such change would have an impact on wording of paragraph 42 and 42A of IFRS 3 and would better reflect the substance of the transactions described in these paragraphs.

Question 4

The Board is proposing the amendments to IFRS 3 and IFRS 11 to clarify the guidance on the definition of a business and the accounting for previously held interests be applied *prospectively with early application permitted. Do you agree with these proposed transition requirements? Why or why not?*

17. ESMA agrees with the transition provisions as retrospective application might require the use of hindsight.