FRC Financial Reporting Council

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24 October 2016

Dear Jean-Paul

IASB Exposure Draft ED/2016/1 *Definition of a Business and Accounting for Previously Held Interests (Proposed amendments to IFRS 3 and IFRS 11).*

Thank you for providing the Financial Reporting Council (FRC) with the opportunity to comment on your draft comment letter (DCL) to the IASB on the Exposure Draft (ED) ED/2016/1 *Definition of a Business and Accounting for Previously Held Interests (Proposed amendments to IFRS 3 and IFRS 11).*

Our responses to EFRAG's 'questions for constituents' and detailed comments on the EFRAG DCL are included in the appendix to this letter. We have also included our response to the IASB for your information.

Definition of a business

In response to the IASB's post-implementation review of IFRS 3 *Business Combinations* (IFRS 3), the FRC highlighted concerns that the definition of a business is too broad, resulting in some transactions which are considered by the acquirer to be, in substance, asset acquisitions being treated as business combinations, leading to a lack of comparability. We agree with EFRAG that the proposed amendments represent an improvement to the existing framework in IFRS 3 for distinguishing business combinations from asset acquisitions, by narrowing the definition of a business and providing clearer criteria and guidance for making this determination. However, we believe that the proposals could go further by reducing or eliminating certain differences between the accounting for business combinations and asset acquisitions for which there is no clear conceptual basis. Aligning the treatment of acquisition expenses, contingent consideration and deferred taxation could reduce the tensions caused in many instances in making the distinction.

Our letter to the IASB highlights several areas where we believe that clarification or additional guidance would be helpful. In particular, in our view, the proposed 'screening test' may require modification to ensure that it is effective in certain cases, such as when the acquisition is a 'bargain purchase'. We also believe that the concept of 'similar' identifiable assets needs to

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be more clearly articulated. The requirement that assets that belong to different classes must not be considered similar may result in types of acquisition that fit the stated purpose of the screening test in paragraph BC18 and are, in substance, asset acquisitions, not being identified as such by the screening test, resulting in unnecessary further analysis.

Our letter also draws attention to some apparent inconsistencies in the ED and highlights a number of aspects of the proposed requirements for determining whether an acquired process is substantive that we believe could be improved, to make their intended application clearer. In particular, we are concerned that the requirement for a set that does not have outputs to include another acquired input in addition to an organised workforce and a critical process in order to constitute a business may, as drafted, unintentionally create potential for manipulation.

Accounting for previously held interests

Like EFRAG, we support the IASB's proposal to clarify the accounting for previously held interests in the assets and liabilities of a joint operation when the entity obtains control of a business that is a joint operation, and when an entity increases its interests in a business that is a joint operation but retains or obtains joint control of that joint operation. In our view, the amendments proposed by the IASB in relation to these matters are consistent with the existing principles in IFRS 3 and IAS 28 *Investments in Associates and Joint Ventures*.

If you would like to discuss these comments, please contact me or Rosalind Szentpéteri on 020 7492 2474.

Yours sincerely

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Appendix

Responses to EFRAG's questions for constituents

Do you consider that the proposed illustrative examples are sufficient to illustrate how the proposed guidance on what is considered a business should be applied? If not, which areas of the proposed guidance should be clarified further in the illustrative examples?

In our letter to the IASB, we identify three areas where we believe that additional examples would help to illustrate how specific aspects of the proposed requirements should be applied. We believe that it would be helpful for the IASB to include additional examples to illustrate:

- on what basis an entity should determine whether a process can be considered 'critical' (the assessment required in paragraphs B12A and B12B(c));
- how the concept of 'control' should be applied, in the context of assessing whether an organised workforce accessed through a contractual arrangement performs a substantive process that the entity controls, as required by paragraph B12C; and
- the application of paragraph BC17, which describes a situation in which an acquired set has outputs at the acquisition date but subsequently generates only intra-group revenues. This additional illustrative example would also help to highlight the difference between the circumstances described in paragraph BC17 and those set out in Example D, where there were no outputs at the acquisition date and therefore the criteria in paragraph B12A are applied (paragraph IE85).

We also agree with EFRAG that several of the examples proposed in the ED are unclear. This is particularly the case in relation to the application of the concept of 'similar' identifiable assets for the purposes of the proposed screening test and the application of the criteria for determining whether a process is substantive.

Many of the matters raised in our letter to the IASB regarding the illustrative examples are substantively the same as those described in the EFRAG DCL. Our letter to the IASB also suggests that:

- The examples intended to demonstrate the application of the proposed screening test are amended to clarify the application of the requirements, particularly if the IASB revises the requirements as suggested in our letter;
- Example D is reviewed in light of the concerns we have raised regarding the potential for manipulation resulting from the requirements of paragraph B12A; and
- Example J is redrafted to clarify that the set it describes is constitutes a business on the basis that the processes acquired 'contribute to the ability to continue producing outputs' and 'cannot be replaced without significant cost, effort or delay in the ability to continue producing outputs' (per the criteria in paragraph B12B(a)), rather than because the acquirer has determined that the processes 'will continue to be performed', as is currently stated in paragraph IE104.

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Finally, we disagree with the assessment in paragraph 38(e) of EFRAG's DCL, which states that the analysis in Example I (paragraph IE99) seems inconsistent with the final sentence of paragraph B11A, which proposes a simplified method for calculating the fair value of the gross assets acquired when applying the screening test. We note that the application of the simplified calculation method is permitted, not mandatory. An acquirer is not prohibited from determining the fair value of the assets acquired on an individual basis, so in our view the approach described in paragraph IE99 is not inconsistent with paragraph B11A.

Do you anticipate any difference in practice in applying IFRS or US GAAP as a result of the differences in wording?

As highlighted in our letter to the IASB, when the IASB and FASB are aiming for and expect converged practice, it is helpful for the same wording to be used so that this is clear. We encourage the IASB and the FASB to reach converged conclusions on their proposed amendments wherever possible.

In particular, we are concerned that the difference in the wording of the proposed screening tests could lead to divergence in practice because the version proposed by the FASB is not explicit that the fair value of gross assets includes the fair value of assets that are not identifiable.

In our view the structure of the IASB ED is clearer, positioning the screening test prior to the detailed requirements for determining whether a process is substantive, which are only applicable to those sets that are not screened out as asset acquisitions.

We also note that paragraphs B12A and B12B refer to a set having outputs 'at the acquisition date' whereas the FASB exposure draft refers to 'a continuation of revenue before and after the transaction'. We believe that the concept of continued revenue generation may be more operational and would reduce the scope for manipulation.

Other matters noted in our letter

The following matters are discussed in our letter to the IASB but are not noted in EFRAG's DCL. It may be helpful for EFRAG to consider these points for inclusion in its final comment letter.

- We suggest that the IASB reduces or eliminates certain differences in accounting in the context of a business combination or asset acquisition for which there is no clear conceptual basis, namely the treatment of deferred tax balances, capitalisation or expensing of transaction costs, and the treatment of contingent consideration.

- While we support the introduction of a screening test to reduce the complexity of applying the requirements in certain cases, we believe that the requirements as drafted are too restrictive for the test to achieve its stated purpose. This may result in unnecessary further analysis of common types of sets that are, in substance, asset acquisitions. In our view, assets that may not be of the same class or similar in form but are inextricably linked in terms of their value and utilisation should be considered as a group of similar identifiable assets for the purposes of the screening test, for example:

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  - a physical asset and its tax attributes (resulting in recognition of a deferred tax asset if the transaction is considered a business combination);
  - land and associated planning permission;
  - a wind farm and its operating license; or
  - a mine and a customer contract to purchase its output.

- We also note that the simplified method for calculating the gross assets acquired for the purposes of the screening test, permitted in paragraph B11A of the ED, may lead to transactions that are, in substance, business combinations being accounted for as asset acquisitions. For example, the calculation will be distorted if the acquisition is a 'bargain purchase'.

- Paragraph B12A states that a set that does not have outputs constitutes a business only if another input has been acquired in addition to an organised workforce and a critical process. This requirement creates the opportunity for the operation of a set to be deliberately suspended prior to the acquisition date so that the only acquired input is the workforce, resulting in a set that would otherwise be deemed to constitute a business being designated as an asset acquisition, only for operations to be resumed shortly afterwards.

- There seems to be an inconsistency between the minimum requirements for a business set out in paragraph B8 and the requirements of B12A. We recommend that the IASB redrafts the first sentence in paragraph B8 because, in our view, it could be interpreted as a narrower requirement than is implied by the terminology used elsewhere in the ED ('ability to contribute to the creation of outputs'). We also believe the wording of paragraph B8 may be contributing to the issues our letter identifies in relation to paragraph BC17.

- In relation to the requirements of paragraphs B12A and B12B, in our view it is unclear on what basis an entity should identify a process as 'critical to the ability to continue producing outputs' but not 'unique or scarce'.

- It is also unclear how the reference in paragraph B12 to the presence of more than an insignificant amount of goodwill as an indicator that a set is a business is intended to interact with the criteria set out in paragraphs B12A and B12B. It is difficult to understand how such an indicator would operate in practice given that the determination of any goodwill balance may be largely dependent on the accounting applied as a result of the assessment of whether the set constitutes a business, and as such it seems illogical to use it as a criterion for that assessment. In our view, this indicator should be deleted.

Drafting comments on EFRAG's DCL

We note that the use of terminology in some parts of EFRAG's DCL is not consistent with the terminology used in the ED. For example, paragraph 16 of the DCL states that a business must include, as a minimum, an input and a substantive process that together '*contribute to the ability* to create outputs' (italics added). Similarly, paragraph 38(c) of the DCL states that paragraph B7 of the ED refers to 'the ability to generate outputs'. It appears that this may be unintentional rephrasing of the requirements in paragraphs B7 and B8, which refer to '*the ability to contribute* to the creation of outputs' (italics added). In our view, the meaning of these phrases is slightly different; the phrasing in the DCL could be interpreted as focusing on the acquiring entity's circumstances and abilities whereas the phrasing in the ED focuses on the

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attributes of the input and process acquired. We do not believe that this is EFRAG's intended to imply a different meaning to that of the language used in ED. That said, we also noted inconsistencies in the IASB's use of terminology and have suggested that the IASB resolves this in the final amendments, to avoid potential confusion.

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24 October 2016

Dear Jawaid

IASB Exposure Draft ED/2016/1 *Definition of a Business and Accounting for Previously Held Interests (Proposed amendments to IFRS 3 and IFRS 11).*

This letter sets out the comments of the UK Financial Reporting Council (FRC) on the Exposure Draft (ED) ED/2016/1 *Definition of a Business and Accounting for Previously Held Interests (Proposed amendments to IFRS 3 and IFRS 11)*. Our main comments on the ED are summarised below and our detailed responses to the consultation questions included in the appendix to this letter.

Definition of a business

We welcome the IASB's objectives in aiming to clarify the definition of a business and providing clearer application guidance to help determine whether an acquired set of activities and assets constitutes a business.

In our response to the IASB's post implementation review of IFRS 3 *Business Combinations* (IFRS 3) in 2014, we highlighted concerns that the definition of a business in IFRS 3 is too broad, resulting in some transactions which are considered by the acquirer to be, in substance, asset acquisitions being treated as business combinations, leading to a lack of comparability.

The tension arising from the distinction between business combinations and asset acquisitions is exacerbated by some of the unnecessary differences, such as those relating to the accounting for acquisition expenses, contingent consideration and deferred taxation. Further consideration should be given to the reduction of elimination of such differences.

Whilst these differences remain, the proposals provide some improvements to the existing framework by narrowing the definition of a business and improving, to some extent the clarity of the criteria and guidance. We believe that the proposals are pragmatic in that we expect them to reduce the level of judgement involved in some cases. However, we believe the proposals could be improved further.

We agree that a business must include, as a minimum, an input and a substantive process that together have the ability to contribute to the creation of outputs. That said, we note some

apparent inconsistencies between the paragraphs describing these minimum requirements and suggest that the IASB redrafts these to ensure that the intended meaning is clear.

Assessment of concentration of fair value (the proposed 'screening test')

We support the inclusion of a mandatory screening test to identify certain transactions as asset acquisitions without the need for further analysis. We expect that addition of this initial step in the assessment process will reduce the complexity of the analysis for those cases that the screening test identifies as asset acquisitions.

However, in our view, the screening test needs to be refined to ensure that it is operational and achieves its intended purpose. We are concerned that the concept of 'similar' identifiable assets is not defined or articulated clearly and that assets that do not belong to the same asset class are excluded from being considered similar. This may result in many types of sets that fit the stated purpose of the screening test in paragraph BC18 and are, in substance, asset acquisitions not being identified as such by the screening test, resulting in unnecessary further analysis.

Furthermore, we note that the method for calculating the fair value of the gross assets acquired that is permitted in paragraph B11A of the ED may not be an effective method for distinguishing asset acquisitions from business combinations in certain cases. For example when a set is acquired as a 'bargain purchase' it may appear that the fair value is concentrated in a single identifiable asset or group of similar identifiable assets when this is not the case. We believe that further guidance for such circumstances or other borderline cases may be required.

Evaluating whether an acquired process is substantive

We agree that there should be two sets of criteria for determining whether a process is substantive depending on whether a set of activities and assets has outputs, and that the two sets of criteria proposed appear to result in appropriate conclusions that reflect the substance of transactions in the majority of cases. However, we are concerned that the requirement for a set that does not have outputs to include another acquired input in addition to an organised workforce and a critical process in order to constitute a business may, as drafted, unintentionally create potential for manipulation. It would also be helpful for the IASB to clarify what constitutes a process that is 'critical to the ability to continue to produce outputs' yet is not a process which is unique or scarce.

Illustrative examples

In our view, examples provide a useful illustration of how requirements and guidance should be applied in practice, particularly in areas where significant judgement is required. That said, we believe that some of the proposed examples are confusing, particularly in relation to whether a group of identifiable assets can be considered 'similar' and whether a process is substantive. We recommend that the IASB clarifies the examples and ensures that they are consistent with the principles in the standard. We have also identified three areas where we believe that additional examples would help to illustrate how specific aspects of the proposed requirements should be applied.

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Convergence with US GAAP

When the IASB and FASB are aiming for and expect converged practice, it is helpful for the same wording to be used so that this is clear. We encourage the IASB and the FASB to reach converged conclusions on their proposed amendments wherever possible.

Accounting for previously held interests

We support the IASB's proposal to clarify the accounting for previously held interests in the assets and liabilities of a joint operation when the entity obtains control of a business that is a joint operation, and when an entity obtains joint control of a business that is a joint operation.

We agree that when an entity obtains control of a business that is a joint operation, previously held interests in that joint operation should be remeasured, because this is a business combination achieved in stages. We also agree that an entity should not remeasure previously held interest in the assets and liabilities of a joint operation when it increases its interest and retains or obtains joint control of that joint operation, because this does not result in a change in the group boundaries.

If you would like to discuss these comments, please contact me or Rosalind Szentpéteri on 020 7492 2474.

Yours sincerely

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Appendix – detailed responses to consultation questions

> **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?

Definition of a business

The FRC has previously highlighted concerns that the definition of a business in IFRS 3 is too broad, resulting in some transactions that are, in substance, asset acquisitions being treated as business combinations. We agree with the IASB's proposal to narrow the definition of a business to state that a business must include, as a minimum, an input and a substantive process that together have the ability to contribute to the creation of outputs. We believe that this minimum requirement will enable companies to differentiate more clearly between asset acquisitions and business combinations.

However, the tension arising from the distinction between business combinations and asset acquisitions is exacerbated by some of the unnecessary differences, such as those relating to the accounting for acquisition expenses, contingent consideration and deferred taxation. Further consideration should be given to the reduction of elimination of such differences.

We support the revision of paragraph B8 to base the assessment of whether a set of activities and assets constitutes a business on the attributes of the set, rather than the capability of market participants to acquire the set and continue to produce outputs from it. We believe that this amendment will reduce the scope for different accounting being applied to similar transactions based, thereby improving comparability.

That said, we note that there seems to be an inconsistency between paragraphs B8 and B12A. Paragraph B8 sets out the minimum requirements for a business, stating that 'to constitute a business, an integrated set of activities and assets must include, as a minimum, an input and a substantive process that together have the ability to contribute to the creation of outputs. However, a business need not include all of the inputs or processes that the seller used in operating that business.' In contrast, paragraph B12A states that, while an organised workforce is an input, in order to constitute a business a set that does not have outputs must also include a substantive process that is 'critical to the ability to develop or convert *another acquired input or inputs* into outputs' (italics added).

The implication of this is that when a set does not have outputs, the set does not constitute a business if the only input in the set is the organised workforce. We are concerned that this requirement may unintentionally create potential for manipulation. For example, the rationale

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for the temporarily closed-down manufacturing facility in Example D not constituting a business is based on this requirement (paragraph IE85). This creates the opportunity for the operation of a set to be deliberately suspended prior to the acquisition date so that the only acquired input is the workforce, resulting in a set that would otherwise be deemed to constitute a business being designated as an asset acquisition, only for operations to be resumed shortly afterwards. We do not believe that this is the IASB's intention and therefore recommend that this requirement is reconsidered.

We also recommend that the IASB redrafts the first sentence of paragraph B8, which states that 'to be capable of being conducted and managed for the purposes defined, an integrated set of activities and assets requires two essential elements–inputs and processes applied to those inputs, which together *are or will be used to create outputs'* (italics added). In our view, this could be interpreted as a narrower requirement that is implied by the terminology used elsewhere in the ED ('the ability to contribute to the creation of outputs').

We support the narrowing of the definition of outputs to exclude returns in the form of lower costs and other economic benefits provided directly to investors and instead focus on goods and services provided to customers and investment income. We agree that many asset purchases (such as the purchase of new manufacturing equipment) may lower costs even though they do not involve the acquisitions of activities and processes. However, we are concerned that the meaning of the reference to 'other revenues' in paragraph B7(c) is unclear.

Paragraph BC17 of the Basis for Conclusions notes that in some cases a business would be integrated by the acquirer in such manner that it no longer generated revenue (for example, when an entity acquires a supplier and subsequently consumes all of the output from that supplier), yet would still be 'capable of generating outputs' so could nonetheless qualify as a business if the relevant criteria in paragraph B12B are met. We recommend that the IASB clarifies in paragraph B7(c) whether the reference to 'other revenues' is intended to ensure that such intra-group revenues are included in the definition of outputs, or means to refer to other types of revenue that are outside the scope of IFRS 15 *Revenue from Contracts with Customers* (for example, revenues within the scope of IFRS 16 *Leases* or IFRS 4 *Insurance Contracts*).

Furthermore, if intra-group revenues are not considered to be outputs, the first sentence of paragraph B8 appears to be inconsistent with paragraph BC17, because the set described in paragraph BC17 is not currently or going to be used to generate external revenues, and therefore should not be considered to be a business. In our view this conclusion would not be appropriate because the assessment of whether a set constitutes a business should be based on the attributes of the set, not how the acquirer intends to operate the set post-acquisition. We recommend that this matter is clarified in paragraph B8.

We note that the ED retains a reference in paragraph B11 to whether a set is capable of being conducted and managed as a business 'by a market participant'. Paragraph BC14 indicates that this is intended to refer to the general perspective of market participants however, in our view, the use of this language may unintentionally detract from the emphasis on the fact that the assessment should be based on the attributes of the set (specifically its ability to contribute to the creation of outputs), rather than the particular circumstances of potential acquirers. We

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therefore recommend that the words 'by a market participant' are deleted. We do not believe that this will impact the intended meaning of the paragraph.

We also suggest that the IASB reviews the use of terminology throughout the ED to ensure that it is used in a consistent manner. For example, the terms 'integrated set of activities and assets' and 'set of activities and assets' appear to be used interchangeably and it is unclear whether they are intended to have the same meaning. Similarly, while many paragraphs refer to 'the ability to contribute to the creation of outputs', paragraphs B12B, IE94, IE107 and BC8 refer to 'the ability to continue producing outputs' and paragraph BC17 refers to 'generating outputs'.

Assessment of concentration of fair value (the proposed 'screening test')

We support the inclusion of a mandatory 'screening test' to enable companies, without the need for extensive analysis, to identify as asset acquisitions cases where substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. We expect that this initial step in the assessment process will reduce the complexity of the analysis for those cases and agree that, in most cases, the screening test would lead to the same conclusion as the application of the proposed guidance on substantive processes.

However, in our view, the screening test needs to be refined to ensure that it is operational and achieves its intended purpose as set out in paragraph BC18 of the Basis for Conclusions. In order for the screening test to be applied consistently, we recommend that the IASB clearly articulates the basis on which a company should determine whether a group of identifiable assets can be considered similar. The ED does not define the term 'similar', only listing in paragraph B11C assets that shall *not* be combined into a single identifiable asset or considered a group of similar identifiable assets. This list may be interpreted as implying that assets in the same major asset classes are similar, whereas some of the illustrative examples imply a higher threshold. In either case we believe this is too restrictive.

We are concerned that, as drafted, the requirements may result in many acquisitions which meet the description in paragraph BC18 and are, in substance, asset acquisitions not being identified as such by the screening test, resulting in unnecessary further analysis. In our view, assets that may not be of the same class or differ in form but are inextricably linked in terms of their value and utilisation should be considered as a group of similar identifiable assets for the purposes of the screening test, for example:

- a physical asset and its tax attributes (resulting in recognition of a deferred tax asset if the transaction is considered a business combination);
- land and associated planning permission;
- a wind farm and its operating license; or
- a mine and a customer contract to purchase its output.

We also believe that the method for calculating the gross assets acquired by adding the fair value of the liabilities assumed to the fair value of the consideration paid (plus the fair value of any non-controlling interest and previously held interest, if any), which is explicitly permitted in paragraph B11A of the ED, may lead to some transactions that are, in substance, business combinations being accounted for as asset acquisitions in certain cases. For example, if the

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acquisition is a 'bargain purchase' this calculation would be distorted and would not produce an accurate measurement of the fair value of the gross assets acquired and therefore would not provide a meaningful basis for the assessment.

While we understand that the proposed calculation method has been designed with a view to ensuring the calculation of the fair value of the gross assets acquired captures, in a simple and cost effective manner, the fair value of inputs, contracts, processes, workforces and any other intangible assets that are not identifiable, we believe that further guidance for 'bargain purchases' or other borderline cases that require a significant amount of judgement may be necessary.

Evaluating whether an acquired process is substantive

We agree that there should be two sets of criteria for determining whether a substantive process has been acquired, depending on whether the acquired set of activities and assets has outputs, because it is appropriate to require more persuasive evidence that a set is a business if the set has no outputs.

The effect of the criteria set out in paragraph B12A is that if a set of assets and activities has no outputs, the absence of an organised workforce means that the set cannot meet the definition of a business. In contrast, the effect of the criteria set out in paragraph B12B is that if a set has outputs but no organised workforce, the set can still meet the definition of a business if it includes a process that is unique or scarce or cannot be replicated without significant cost, effort or delay in the ability to continue to produce outputs.

In our view it is not clear why, on a conceptual basis, the absence of an organised workforce should be the decisive factor when assessing whether a process is substantive in the context of a set that has no outputs at the date of acquisition. Nevertheless, from a pragmatic perspective the application of the criteria proposed in paragraph B12A appears to result in appropriate conclusions that reflect the substance of transactions. We therefore consider the proposed criteria to be an improvement on the existing guidance. That said, we note that the relevance of the absence of an organised workforce as a criterion may decline over time given the increasing automation of business processes. With this in mind, the IASB may need to monitor whether these criteria continue to be appropriate in the future.

We agree that a process that is unique or scarce, or cannot be replaced without significant cost, effort or delay in the ability to continue producing outputs (as described in paragraph B12B(a), would usually have significant fair value and the presence of such a process in a set is therefore a strong indication that the set is a business, even in the absence of an organised workforce.

The effect of paragraphs B12A and B12B(b) is that when a set includes an organised workforce, at least one other acquired input and a process which is 'critical to the ability to continue producing outputs', that set it a business. In our view, it is unclear what constitutes a process which is 'critical' yet is not unique or scarce. Paragraph BC26 states that a critical process may be 'widely available' and implies that it may not be valuable, in contrast to a process that is unique or scarce. It is difficult to understand in what sense a process should be considered critical if it has minimal value and can easily be recreated or sourced from other market participants. The final sentence of paragraph B12A explains that ancillary or minor

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processes are not critical however, it is not clear whether this is intended to imply that all non-ancillary, non-minor processes are critical, and on what basis such an assessment should be made. We recommend that the IASB provides further guidance on assessing whether a process is critical and provides examples to illustrate how this assessment should operate.

It is also unclear how the reference in paragraph B12 to the presence of more than an insignificant amount of goodwill as an indicator that a set is a business is intended to interact with the criteria set out in paragraphs B12A and B12B. It is difficult to understand how such an indicator would operate in practice given that the determination of whether goodwill is present would take place after the assessment of whether the set is a business. For example, if the set consists of a property inside a corporate wrapper, the assessment of whether the acquisition is a business combination will drive the determination of whether there is a deferred tax balance to be recognised due to the different accounting applied to business combinations and asset acquisitions. The determination of any goodwill balance may therefore be largely dependent on the assessment of whether the set constitutes a business, and as such it seems illogical to use it as a criterion for that assessment. We therefore recommend that the first two sentences of paragraph B12 are deleted.

Paragraph B12C discusses circumstances when an organised workforce is accessed through an acquired contract. We agree that the relevant consideration is whether this organised workforce performs a substantive process that the entity controls because it is the substance of the transaction that is relevant when determining whether an acquired set constitutes a business, not its contractual form.

Illustrative examples

In our view, examples can be useful in clarifying the application of the principles in the standard, particularly in cases that require significant judgement. We believe that it would be helpful for the IASB to include additional examples to illustrate:

- on what basis an entity should determine whether a process can be considered 'critical' (the assessment required in paragraphs B12A and B12B(b));
- how the concept of 'control' should be applied, in the context of assessing whether an organised workforce accessed through a contractual arrangement performs a substantive process that the entity controls, as required by paragraph B12C; and
- the application of paragraph BC17, which describes a situation in which an acquired set has outputs at the acquisition date but subsequently generates only intra-group revenues. This additional illustrative example would also help to highlight the difference between the circumstances described in paragraph BC17 and those set out in Example D, where there were no outputs at the acquisition date and therefore the criteria in paragraph B12A are applied (paragraph IE85).

In our view, some of the examples proposed in the ED are confusing in their illustration of how the requirements should be applied. This is primarily the case in relation to the examples that are intended to illustrate the application of the concept of 'similar' identifiable assets for the purposes of the screening test and the application of the criteria for determining whether a process is substantive.

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In particular, we note that the illustrative examples could be improved in relation to the following matters:

- The examples do not help to clarify which factors determine whether a group of assets can be considered 'similar'. Example A (paragraph IE75(b)) refers to assets being 'similar in nature' and describes as similar a group of assets because they form a specific category of assets with similar characteristics, within an asset class ('all single-family homes'). In contrast, Example H (paragraph IE96(c)) refers to a broad class of tangible assets ('all office buildings') as similar, irrespective of their characteristics. Many of the other examples also seem to imply that the assessment should be based on asset class, and we note that this is the focus of the factors set out in paragraph B11C that prohibit a group of assets being considered similar if they belong to different asset classes. In our view, the screening test will be more effective if it identifies as asset acquisitions groups of assets that are inextricably linked, not just those that belong to the same asset class. We suggest that the illustrative examples are redrafted to clarify the application of these requirements.

- Example C is titled 'acquisition of a television station' yet states that 'the set of activities and assets does not have outputs' (paragraph IE82). In our view, a television station has outputs by definition, such as the programme content transmitted. It is also difficult to understand how a set of activities and assets could be deemed to be a television station without an organised workforce to operate it. We recommend that Example C is retitled 'acquisition of broadcasting assets'.

- It appears that Example D is intended to illustrate the requirement in paragraph B12A that, when a set does not have outputs, it must include a workforce, a critical process and another acquired input or inputs that can be converted into outputs. As set out above, we believe that this requirement may create potential for manipulation and Example D may need to be amended if this requirement is revised. In any case, it appears that a temporarily closed-down manufacturing facility would retain 'the ability to contribute to the creation of outputs'. It seems counter-intuitive to conclude that it does not constitute a business on the basis that it happens to have depleted levels of inventory. We also find other aspects of Example D confusing. The basis for the conclusion that there is an organised workforce is unclear. Paragraph IE83 states that the purchaser 'hires the employees that worked in the facility'. It is implausible that the purchaser would be able to hire precisely the same workforce that previously operated the manufacturing facility when the facility has already been closed down, albeit temporarily. It is also unclear whether the contracts with these employees form an integral part of the set acquired or were arranged separately, on an individual basis.

- Example J (paragraph IE104) states that the set acquired does not include an organised workforce but that 'operational processes are in place and *will continue to be performed* through existing infrastructure' (italics added). It is not clear how the operational processes described will continue to operate in the absence of an organised workforce to perform them. Given the nature of the business, it doesn't seem plausible that the processes could be fully automated. While it is possible that the acquirer has suitably skilled employees that it could assign to operate the set as a business, the assessment of whether the set is a business must be based on the attributes of the set rather than the resources or intentions of the acquirer. Paragraph B12B(a) requires that the process (or group of

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processes) acquired 'contributes to the ability to continue producing outputs' and 'cannot be replaced without significant cost, effort or delay in the ability to continue producing outputs', rather than a determination that the processes acquired 'will continue to be performed'. We suggest that the rationale for this example is redrafted in the context of the criteria in paragraph B12B(a).

> **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?

We understand that the IASB's proposed amendments to IFRS 3 and the FASB's Proposed Accounting Standards Update *Clarifying the Definition of a Business* are based on substantially converged tentative conclusions but are structured and worded differently in a number of places.

When the IASB and FASB are aiming for and expect converged practice, it is helpful for the same wording to be used so that this is clear. We encourage the IASB and the FASB to reach converged conclusions on their proposed amendments wherever possible. As a minimum, in our view, the reasons for specific differences in the wording of the proposed amendments to IFRS 3 and Topic 805 *Business Combinations* should be explained in the Basis for Conclusions.

In particular, we are concerned that the difference in the wording of the proposed screening tests could lead to divergence in practice because the version proposed by the FASB is not explicit that the fair value of gross assets includes the fair value of assets that are not identifiable.

In our view the structure of the IASB ED is clearer, positioning the screening test prior to the detailed requirements for determining whether a process is substantive, which are only applicable to those sets that are not screened out as asset acquisitions.

We also note that paragraphs B12A and B12B refer to a set having outputs 'at the acquisition date', with B12B referring to an example of an entity generating revenue prior to the acquisition date. The equivalent paragraph in the FASB exposure draft instead refers to 'a continuation of revenue before and after the transaction'. We believe that the concept of continued revenue generation may be more operational than basing the determination on whether revenue is generated a particular point in time, and would reduce the scope for manipulation that we have identified in relation to cases such as that set out in Example D.

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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 remeasure 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 remeasure 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?

Yes, we agree with the proposed amendments to IFRS 3 and IFRS 11 *Joint Arrangements.* We support the IASB's proposal to clarify the accounting for previously held interests in the assets and liabilities of a joint operation when the entity obtains control of a business that is a joint operation, and when an entity obtains joint control of a business that is a joint operation.

We agree that when an entity obtains control of a business that is a joint operation, previously held interests in that joint operation should be remeasured in accordance with paragraph 42 of IFRS 3, because this is a business combination achieved in stages.

We also agree that an entity should not remeasure previously held interest in the assets and liabilities of a joint operation when it increases its interest and retains or obtains joint control of that joint operation, because this does not result in a change in the group boundaries. We agree that this situation is analogous with the existing principle in paragraph 24 of IAS 28 *Investment in Associates and Joint Ventures*, which states that when an investment in an associate becomes an investment in a joint venture (or vice versa), the entity does not remeasure the previously held interest, because the entity continues to apply the equity method after the transaction.

We note that paragraph BC3 of the proposed amendments to IFRS 11 could imply a wider scope than intended for the proposed amendments to paragraph B33C. Paragraph BC3 refers to cases when 'an investor obtains joint control of a business that is a joint operation'. We believe that the proposals intend to capture only transactions for which the previously held interests were accounted for in accordance with IFRS 11 both before and after the transaction (i.e. those cases where the entity was previously party to the joint operation). We recommend that the IASB clarifies the wording of paragraph BC3 to avoid any potential confusion.

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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?

Yes, we agree with the proposed transition requirements. In our view, it is appropriate for the proposed amendments to be applied prospectively because the costs of retrospective application would outweigh the benefits and, in some cases, retrospective application is likely to be impracticable.

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