A Closer Look

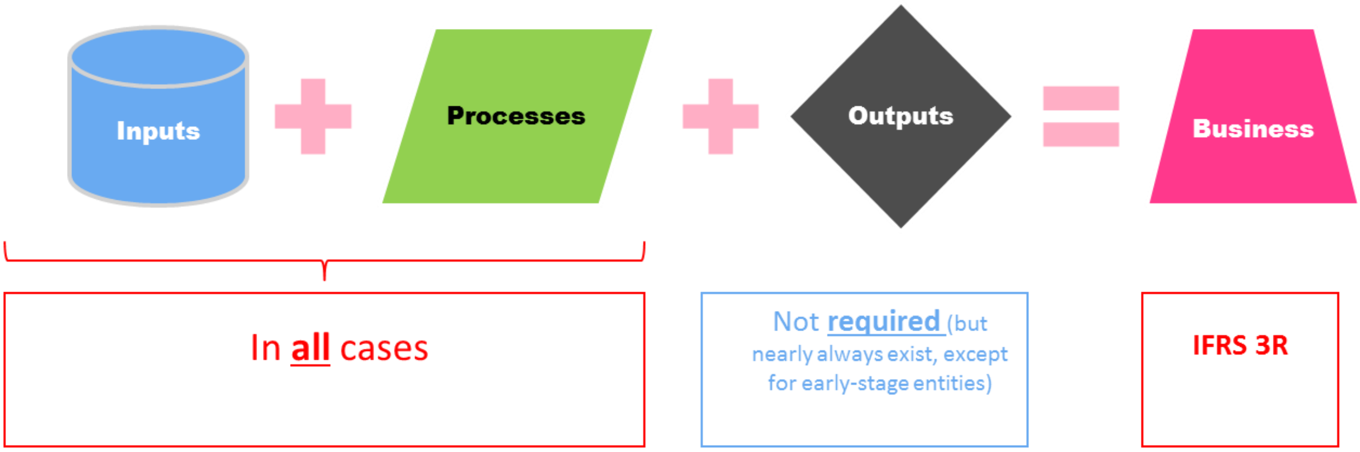
Proposed amendments to IFRS 3 – Business Combinations and and IFRS 11 Joint Arrangements

IFRS 3 – Clarifying the definition of a business

Following the Post-implementation Review (PIR) of IFRS 3, and the discussions held by the IFRS Interpretations Committee in November 2015 and by the IASB in March 2016, the Board has decided to review the definition of a 'business'.

We must remember first of all that a business involves:

- inputs;
- processes; and
- usually, outputs.



a) A new approach to identifying a business

In practice, the amendments include some changes to the definitions of the various elements that constitute a business, as well as a new two-stage approach to identifying whether a transaction involves a business.

The first stage involves an assessment of whether substantially all of the fair value of the assets acquired is concentrated in a single asset (or a group of similar assets).

If the fair value of the assets is not concentrated in a single asset, the amendment proposes the use of a decision tree to assess whether one or more substantive processes have been acquired. Different situations are discussed, depending on whether or not the acquired set of activities and assets has the ability to generate outputs.

b) Changes to the definitions of the various elements

The new definition of outputs places more emphasis on goods and services provided to customers (to ensure consistency with the definition of 'output' in IFRS 15).

The new definition no longer specifies that the acquired elements should have the ability to reduce costs (or provide other economic benefits).

However, the proposed amendments stipulate that the acquired process(es) must be substantive and must have the ability to contribute to the creation of outputs.

The proposed definition removes the reference to 'market participants', which applied in situations when the acquired elements did not include all of the elements used by the seller. The Board felt that different acquirers might have different opinions on what a market participant's perspective might be.

Finally, the presence of a more-than-insignificant amount of goodwill no longer creates the presumption that a set of assets and activities is a business. The presence of goodwill is now simply an 'indicator' that the acquired assets and activities may constitute a business. It is, therefore, still necessary to carry out a full assessment.

c) First stage of the assessment: the concentration of fair value test

This new stage in the process is intended to make the assessment easier. If certain criteria are met, there is no need to carry on through the rest of the decision tree.

In practice, this new stage involves determining whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset (or a group of similar assets). If it is, the transaction does not involve a business.

A single identifiable asset is one that would be recognised as such in a business combination.

Thus, in practice, a building leased to a third party under an operating lease would not be broken down into a building and an intangible asset (i.e. the lease) but would be treated as a single identifiable asset.

Under the proposed amendments, entities would not be permitted to combine different classes of assets when assessing the concentration of fair value:

- Tangible and intangible assets;
- Different classes of intangible assets (trademarks, patents, customer relationships, etc.);
- Different classes of tangible assets (for example, inventory and manufacturing equipment, except in situations where assets cannot be physically separated without incurring significant cost or loss of value);
- Financial assets and non-financial assets;
- Different classes of financial assets (accounts receivable, marketable securities, cash, etc.).

The fair value of the gross assets is not the same as the transaction price, as it also includes the fair value of any liabilities, the fair value of any non-controlling interests and the fair value of any previously-held interest in the entity.

If the fair value of the gross assets is concentrated in a single asset, or a group of similar assets, the Board considers that the transaction does not involve a business. Thefore, in practice, there is no need to continue with the assessment.

d) Second stage: assessing whether one or more substantive processes have been acquired

If the concentration of fair value test does not conclude the assessment, the entity must proceed to the second stage. The assessment criteria for this stage differ, depending on whether or not the acquired assets and activities have outputs at the acquisition date.

If the acquired assets and activities do not have any outputs, the proposed amendments state that a substantive process can only exist if the inputs include an organised workforce that is capable of generating outputs. In other words, the presence of a workforce with responsibility for ancillary functions would not be enough to qualify the acquired assets and activities as a business.

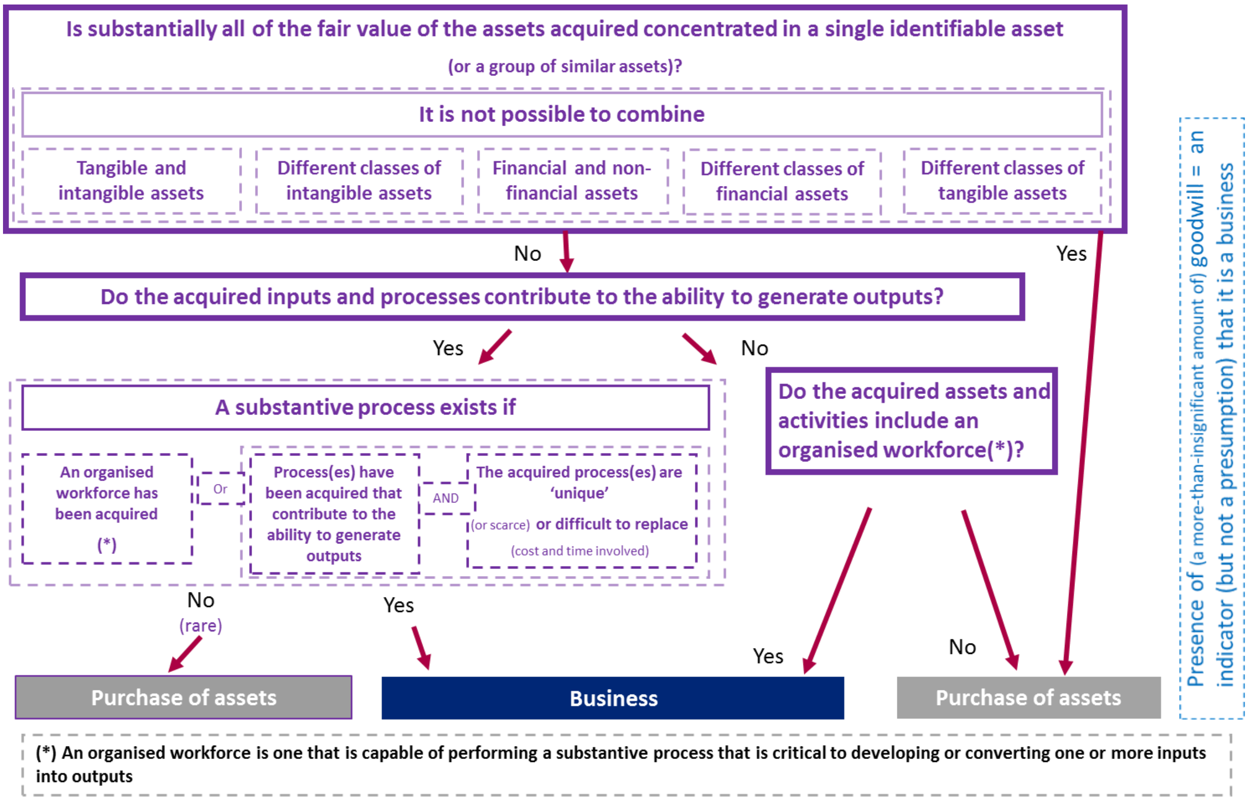
If the acquired assets and activities do have outputs, a substantive process is deemed to exist in the following situations:

- If an organised workforce (i.e. one that is capable of generating outputs) has been acquired; OR
- If the acquired assets and activities include processes that contribute to the ability to generate outputs, and these processes are 'unique' or 'scarce', or cannot be replaced without significant cost or delay.

The proposed amendments to IFRS 3 include numerous illustrative examples, showing how the assessment process would work in specific situations.

e) Purchase of assets vs. business combination - in summary

The proposed amendments include a partial decision tree. We here provide a more complete version, drawing on the further details and examples provided:



Key points to remember

- The definition of a business has changed only slightly.
- The amendments clarify the process for assessing whether the transaction is a business combination or a purchase of assets, through additional guidance and several illustrative examples.
- A 'concentration of fair value' test has been introduced, allowing entities to quickly identify certain situations in which the transaction is a purchase of assets rather than a business combination.
- The acquisition of an organised workforce with the skills to generate outputs is a key indicator that the acquired assets and activities may constitute a business.

IFRS 11 – Acquisition of an interest in a joint-operation

The IASB wished to clarify the accounting treatment of the acquisition of interests in joint operations, depending on whether or not the entity obtains control (i.e. exclusive control) of the joint arrangement. This clarification was necessary as it became apparent that there was diversity in practice.

Readers will remember that IFRS 11 distinguishes between different types of joint arrangement:

- **Joint ventures**
  In the (most common) situation where the parties only have rights to the net assets of the joint arrangement, they account for their interest using the equity method.
- **Joint operations**
  In the (rare in practice) situation where the parties have rights to the assets and obligations for the liabilities of the joint arrangement, they recognise their share of the assets and liabilities (and revenue and expenses). In other words, the accounting method is similar to proportionate consolidation.

  In practice, if the rights to the assets and obligations for the liabilities of the arrangement are equal, the same accounting method is used by joint operators as by parties to an arrangement who do not share joint control.

In practice, given that joint operations are relatively rare, the clarifications will not change the accounting treatment in many situations.

a) Situations in which an entity obtains control (i.e. exclusive control) of a joint arrangement

The amendment stipulates that in a situation in which an entity obtains control (i.e. exclusive control) of a joint arrangement, it shall remeasure its previously held interests in the assets and liabilities of the joint arrangement at fair value through profit or loss.

This accounting treatment is based on the same logic as step acquisitions. The same accounting treatment is used, irrespective of whether the entity was a joint operator or simply a party to the arrangement (i.e. without joint control).

b) Situations in which an entity does not obtain exclusive control of a joint arrangement

In a situation in which an entity does not obtain exclusive control of a joint arrangement, the acquisition of a further interest in a joint arrangement shall not give rise to remeasurement of its previously held interests.

The logic behind this is that the scope of consolidation is not affected by the transaction. Furthermore, this accounting treatment is consistent with that for transactions in which an entity moves from having significant influence to joint control (or vice versa). The Board felt that such transactions were comparable.

The same accounting treatment is used for situations in which the acquisition of an additional interest gives the entity joint control (when previously it participated in the joint arrangement but did not have joint control).

Key points to remember

- This amendment to IFRS 11 will only apply in a small number of situations.
- If an entity gains exclusive control over a joint operation, assets and liabilities previously accounted for under IFRS 11 shall be remeasured at fair value.
- If the acquisition of additional interests does not give the entity exclusive control, no remeasurement shall take place. The entity shall simply recognise an additional share of the assets and liabilities.

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