



Mr Hans Hoogervorst
Chairman
International Accounting
Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Sent by email:
Commentletters@ifrs.org

Brussels, 19 October 2016

Subject: The Federation of European Accountants comments on IASB Exposure Draft: Definition of a Business and Accounting for Previously Held Interests (ED/2016/1)

Dear Mr Hoogervorst,

The Federation of European Accountants (www.fee.be) is pleased to provide you below with its comments on the IASB's Exposure Draft (ED) Definition of a Business and Accounting: Proposed amendments to IFRS 3 *Business Combinations* and IFRS 11 *Joint Arrangements*.

Definition of a business

- (1) Overall, the proposed amendments to IFRS 3 are an improvement compared to existing guidance. The proposals are expected to address most of current issues.
- (2) We have identified some areas where the guidance would benefit from a better balance between a rule based and a principle based approach related to the 'screening test' and the existence of an organised workforce when no output exists.
- (3) This would allow stakeholders to exercise their professional judgement in the more complex circumstances, which would enhance the relevance of the financial statements.
- (4) While we agree that the acquisition of an organised workforce to perform an acquired substantive process is a key factor in assessing whether an acquired set constitutes a business, we recommend the IASB to clarify the notion of work force, as it is not clear whether the IASB is referring to the criticality of a specific work force (not replaceable) or to the functionality of the work force (replaceable). Also, it is not clear how the existence of an organized work force, which is considered to be an input by the IASB, can allow to meet the "substantive process" criteria to conclude that it is a business when there is no output.

- (5) We agree with the presence of more than an insignificant amount of goodwill being an indicator that an acquired process is substantive. Nevertheless, the IASB should clarify how the assessment of this indicator interacts with the rest of the guidance, both when the set of activities have outputs or do not have outputs. The IASB should also clarify how the goodwill is determined for purposes of assessing this indicator.
- (6) Furthermore, we appreciate the IASB's efforts to give practical examples of how to apply the framework for concluding whether an acquisition meets the requirements of a business or an asset. In general, the examples are useful because they help illustrate the accounting principles. However, some examples would need to be reconsidered or be further clarified.
- (7) It would also have been beneficial if the IASB had addressed whether a differentiated treatment for acquisitions of assets as opposed to acquisitions of business is justified. Indeed, while this differentiated treatment is conceptually justified with respect to goodwill, we have doubts when it comes to the other differences in accounting treatment.
- (8) Moreover, we appreciate the efforts made by the IASB and the FASB to develop a fairly similar and consistent model for the definition of a business. We urge both the IASB and the FASB to continue their close collaboration in finalising their projects to eliminate any differences as much as possible. It is especially important for both standards to have the same terminology. In principle any different wording may result in different accounting treatment or assessment. However, given the timing difference between the FASB's project and the IASB's project, we acknowledge it might not be possible to achieve this objective of alignment. In such instance, the IASB should give priority to addressing the concerns raised as part of the consultation process. Even if this might result in GAAP differences, to the extent it is considered that the IASB's proposal offers a robust model in improving the quality of financial statements.

Accounting for previously held interests

- (9) We do not disagree with the proposals to clarify the accounting in IFRS 3 and IFRS 11. However, we would expect more clarifications in the Basis for Conclusions to understand the conceptual basis for the principle, given the tensions between the core principles of IFRS 11 and those of IFRS 3. Alternatively, the IASB could also consider deferring those amendments as part of its post-implementation review of IFRS 11 in order to assess those narrow scope issues as part of a complete assessment of IFRS 11.

Our detailed responses to the questions included in the Proposal are set out in the Annex below. For further information on the Federation's letter, please contact Eleni Ashioti on +32 (0)2 8933387 or via email at eleni.ashioti@fee.be from the Federation's team.

Kind regards,

On behalf of the Federation of European Accountants,



Petr Kriz
President



Olivier Boutellis-Taft
Chief Executive

Annex 1 -Detailed comments to the IASB's 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 (i.e. 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) Overall, we believe that the proposed amendments to IFRS 3 are an improvement compared to existing guidance. Under current guidance, some transactions were treated as business combinations while some stakeholders were viewing those as purchases of groups of assets. The guidance is also not applied consistently giving rise to diversity in practice. The Federation believes that the proposed guidance should address those issues.

Definition of a business (application of paragraph 3)

- (2) We agree that to be a business a set of assets and activities must include, at a minimum, an input and a substantive process that together contribute to the ability to create outputs. In addition, we agree that the existence of a substantive process differentiates an acquisition of a business from an acquisition of an asset.

Assessment of concentration of fair value

- (3) The Federation welcomes the introduction of the 'screening test' and of the term 'substantially' all. We acknowledge that this term is already used throughout the IFRS literature. The threshold is appropriate and would be operable. The approach taken would be practical and straight forward to evaluate whether a transaction is not a business. We agree with not introducing a bright line value threshold within the standard as the determination of 'substantially all' would depend on the characteristics and the nature of the gross assets concentrated in a single identifiable asset.
- (4) Nonetheless, we are concerned that some transactions that could be considered business combinations would instead be accounted for as asset acquisitions if the 'screening test' is retained as a mandatory quantitative test. Therefore, we suggest considering the 'screening test' to be a rebuttable presumption instead of a decisive factor to allow users to exercise their professional judgement and consider all relevant factors before resulting to a conclusion. This can be illustrated by a situation where substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets but the transaction also includes an organised workforce which has a low fair value but meets the criteria in B12A. If the organised workforce is considered to be a substantive process it would alternatively signify that the set of activities is a business.
- (5) We also wonder why should the assessment in paragraph B11B only looks at a combination of tangible assets and not a combination of intangible assets or a combination of tangible and intangible assets. For example, a product might combine different pieces of intellectual properties which cannot be separated from each other. For example, a casino license can only be considered jointly with the related building. We suggest to extend the wording to something more comprehensive than strictly tangible assets.

Evaluating whether an acquired process is substantive

- (6) We support the core principles of the guidance on evaluating whether an acquired process is substantive. However, we encourage the IASB to clarify further certain aspects of the proposal to achieve greater consistency and less complexity in its application.
- (7) We agree that the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive. However, we have the following concerns relating to this indicator:
 - a) The IASB should clarify how the assessment of this indicator interacts with the rest of the guidance, both when the set of activities have outputs or do not have outputs. For example, it is not clear what the conclusion would be if there is a goodwill but no output.
 - b) The IASB should also clarify how the goodwill is determined for purposes of assessing this indicator. For example, goodwill could arise primarily from deferred tax liabilities that would be recognised in a business combination. But those deferred tax liabilities, even if significant, would not reflect the value of substantive processes. Another example would be a bargain purchase giving rise to negative goodwill; we wonder how the goodwill indicator would be assessed in this situation.
- (8) We welcome the guidance provided in B12C on how to determine, in the case that an acquired contract gives access to an organised workforce, whether the acquirer has control over the organised workforce. However, it is a difficult area of judgement, where diversity in practice is observed and we are concerned that the guidance might not be sufficient to allow stakeholders to exercise their judgement. We recommend the IASB to provide an example to illustrate how this guidance can be applied. For example, in the pharmaceutical industry, an entity might acquire both a product and a transition agreement with a third party, which will manufacture the products for a few years, allowing time to the pharmaceutical entity to develop its own manufacturing process. It would be useful to explain which factors would need to be considered to assess whether the set of activities includes a substantive process.
- (9) We agree that the acquisition of an organised workforce to perform an acquired substantive process is a key factor in assessing whether an acquired set constitutes a business. However, we have the following concerns regarding the workforce:
 - a) We perceive a tension between the objective of paragraphs B12-B12C which are aiming at evaluating whether an acquired process is substantive and Paragraph B12A which states that, when there is no output, the set of activities and assets is a business only if it includes an organised workforce, while the IASB considers that the workforce is an input and not a process. A similar tension exists between the assertion that an organised workforce is an input and the definition of a process in paragraph B7 which states that “the intellectual capacity of an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs”. We recommend that the IASB addresses this tension.
 - b) We also encourage the IASB to clarify whether the assessment of the workforce should be made over the criticality of the individuals comprising a workforce which cannot be easily replaced (for example, a scientist who is key to develop further a product), or over the function of a workforce which is easily replaceable.

- (10) Similarly, while we agree that the assessment of whether a particular set of activities and assets is a business should be made from the perspective of a market participant (B11) with the objective to have similar transactions being accounted for in the same way (BC14), we are concerned that the application of paragraph B12A might result in similar transactions being accounted for differently. For example, if a set of activities and assets includes a workforce, but at the acquisition date, the workforce is excluded from the transaction and is rehired separately (same or different workforce), the application of paragraph B12A would result in concluding that the acquired set does not constitute a business. We are not convinced that it would be an appropriate conclusion in this specific situation. We would therefore recommend that this criteria of paragraph B12A be presented as a rebuttable presumption, which would allow stakeholders to exercise their judgement considering all relevant facts and circumstances.
- (11) Including a diagram based on the wording of paragraphs B12A and B12B would also be helpful to the users.

Amendments to the illustrative examples of IFRS 3 Business Combinations

- (12) We appreciate the IASB's efforts to give practical examples of how to assess whether an acquisition meets the requirements of a business or an asset. In general, the examples are useful because they help illustrate theoretical and/or abstract areas. However, some examples should be further clarified and/or be more realistic.

(13) Examples A, H and I – Acquisition of investment properties

We wonder whether examples A and H sufficiently differentiate themselves from example I to the extent that in practice the majority of the value of the acquired set of activities and assets lies in the properties, not in the value of the employees and the processes. Having such a large difference between examples H and I simply because of the acquired workforce looks artificial, even though the conclusion is different. It implies also that if there was not a significant value associated with the acquired workforce, we would have concluded that the set of activities and assets acquired is not a business according to the 'screening test'. However, at the same time, one could also argue that the set is a business including both inputs (land, buildings, leases) and a substantive process (organised workforce - meeting the requirements of paragraph B12A) that have the ability to contribute to the creation of output. Our recommendation to consider the 'screening test' as a rebuttable presumption could possibly resolve this ambiguity. Refer to our comment in paragraph 4 for more details.

(14) Example B – Acquisition of a drug candidate

In this example, it is concluded that the set of activities and assets purchased is not a business because substantially all of the fair value of the gross assets acquired is concentrated in a single asset. The assessment seems to ignore the existence of the know-how, formula protocols, designs and procedures which could be considered as substantive processes. It also ignores the outsourcing contracts, despite the guidance of paragraph B12C which suggests that the acquirer might have access to an organised workforce through those contracts.

(15) Example C – Acquisition of a television station

The fact pattern assumes that the set of activities does not have outputs. This does not seem realistic as we would expect a television station to air programs which would be outputs. We recommend the IASB to either change the fact pattern or to change the title of the example (e.g. Acquisition of television equipment).

(16) Example D – Acquisition of a manufacturing facility

It is not clear what the rationale of the conclusion is:

a. It is concluded that the set of activities and assets purchased is not a business because there is no other acquired input that the workforce could develop or convert into inputs. It would be useful to clarify what are the factors which the IASB considered when reaching the conclusion in light of paragraph B8 (“to constitute a business, an integrated set of activities and assets must include, at a minimum, an input and a substantive process that together *have the ability to contribute* (emphasis added) to the creation of outputs. However, a business need not include *all* (emphasis added) of the inputs or processes that the seller used in operating the business”) and BC17 (“although the acquired supplier no longer generates revenue after the transaction, the acquired inputs and processes would still be capable of generating outputs and so could qualify as a business”).

b. We question why a temporarily closed-down manufacturing facility which has always been a business would suddenly result in not being accounted for as a business. We would assume that, it could be reopened at any time.

c. We question whether acquiring some inventory would have changed the conclusion. For example, raw materials inventory could probably be converted into outputs by the employees through the use of the acquired equipment.

(17) Example K – Acquisition of mortgage loan portfolio

We also wonder how realistic this example is as it is difficult to see why an entity would pay a significant amount to acquire an organised workforce in an acquisition of a mortgage portfolio, where the work force acquired does not seem to be involved in the development of new businesses.

Other comments

- (18) We acknowledge that the proposed guidance will address most of the concerns expressed in the Post Implementation Review (PiR): IFRS 3 Business Combinations. While recognising this, we also reiterate our response to the IASB on the ‘Request for Information - PiR: IFRS 3 Business Combinations’ where we stated that one of the key issues to be addressed is whether the differentiated treatment for acquisitions of assets as opposed to acquisitions of business is justified. This differentiated treatment is conceptually justified with respect to goodwill, we have doubts when it comes to the other differences in accounting treatment. For items such as deferred tax, contingent consideration and transaction costs, the difference in treatment appears justified by practical considerations rather than conceptually. For transactions costs, the difference in treatment highlights the fact that current IFRS require that acquisition of a business is recognised at fair value while acquisition of most non-financial assets is recognised at cost. The justification of this fundamental difference is not self-explanatory and would need to be further investigated.

Question 2

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?

- (19) We recognize that the FASB's proposals are closely aligned with IFRS and that its objective is to narrow the definition of a business.
- (20) It is encouraging that the IASB and the FASB are engaged in a fairly similar approach in improving the 'Definition of a Business'. Their constructive relationship provides further transparency to primary users about the accounting treatment of an acquired set of activities and assets.
- (21) We urge both the IASB and the FASB to continue being converged and closely work together in finalizing their projects to eliminate any differences as much as possible. Especially, it is important to both standards to have the same terminology. In principle, any different wording may result in a different accounting treatment or assessment. Therefore, this will help to the consistent application of the definition in practice, especially to companies which report under both IFRS and US GAAP.
- (22) However, given the timing difference between the FASB's project and the IASB's project, we acknowledge it might not be possible to achieve this objective of alignment. In such an instance, the IASB should give priority to addressing the concerns raised as part of the consultation process, even if this might result in GAAP differences, to the extent it is considered that the IASB's proposal offers a robust model in improving the quality of financial statements.

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?

- (23) Overall, we do not disagree with the proposal to clarify the accounting in IFRS 3 for previously held interests in the assets and liabilities of a joint operation when an entity obtains control of a business that is a joint operation. However, under IFRS 3 the equity itself is remeasured when accounting for a step-acquisition and not the underlying assets and liabilities. Therefore, we would expect the IASB to clarify, in the Basis for Conclusions, how it reconciles this proposal with:
- the fact that the remeasurement basis would be applied for all the underlying assets- the joint operator's own assets and liabilities as well as those held jointly, which appears inconsistent with the principal of a joint operation under IFRS 11,
 - the accounting for business combinations achieved in stages under IFRS 3 which is based on the notion of exchange of an equity interest against its underlying net assets (IFRS 3. BC384).

We recommend also adding an example, to help users understand how to account for such a transaction in practice.

- (24) Furthermore, we support the proposals to clarify the accounting in IFRS 11 for previously held interests in the assets and liabilities of a joint operation when an entity obtains joint control of a business that is joint operation. We agree that the transaction is similar to the one indicated in paragraph 24 of IAS 28 *Investment in Associates*. We also recommend adding an example to illustrate how to apply this principle.
- (25) We understand that the proposals address the situations for which the previously held accounting interests were accounted for under IFRS 11 before and after the transactions i.e. the investor who obtains joint control was previously a party that has rights to the assets and the obligations for the liabilities relating to the joint operation. While guidance in B33C is sufficient, we suggest related clarifications in paragraph BC3 of the Basis for Conclusions on the proposed amendment to IFRS 11 because the paragraph might imply that the proposals also include conditions where the investor was not previously a party to the joint operation.
- (26) Alternatively, the IASB could also consider differing those amendments as part of its post-implementation review of IFRS 11 in order to assess those narrow scope issues as part of a complete assessment of IFRS 11.

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?

- (27) Yes, we agree. Prospective application, with early application permitted, would be operational and cost effective.