



Definition of a business under IFRS 3 revised

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Overview

The revised IFRS 3 *Business Combinations*, (IFRS 3R) changed the definition of a business from the previous version of IFRS 3. While this new version seems to broaden the definition and requires more judgment to be applied, the basis for conclusion explains that this was merely an improvement on the IFRS definition to avoiding ‘unduly restrictive interpretations’ particularly relating to start-up entities. As such, we do not believe that this change should result in a significant change to what a business is in other circumstances. However, the determination of whether an acquired set of assets and activities is a business still requires significant judgment. The determination of whether an acquired set of activities and assets represents a business is critical because the accounting for a business combination differs significantly from the accounting for an asset acquisition.

The significant judgment required to conclude whether an acquired set of activities and assets is a business, together with the significant implications of such determination, means that companies should carefully evaluate the specific facts and circumstances when applying the new guidance in IFRS 3R.

Business combination versus asset acquisition

The conclusion as to whether an acquired set of activities and assets is a business can lead to significantly different accounting results. If an acquired set of activities and assets does not meet the definition of a business, the transaction is accounted

for as an asset acquisition based on the principles described in other IFRS. There are many differences in the accounting for a business combination versus an asset acquisition, such as the following:

- ▶ Goodwill or a gain on a bargain purchase arise only in a business combination
- ▶ The initial measurement of assets acquired and liabilities assumed is generally fair value in a business combination versus allocated cost (on a relative fair value basis) in an asset acquisition
- ▶ Directly attributable acquisition-related costs are expensed in a business combination, but may be capitalised in an asset acquisition, to the extent that such capitalisation does not result in an immediate impairment
- ▶ Deferred tax assets and liabilities arising on initial recognition are recognised in a business combination, but not in an asset acquisition¹
- ▶ Disclosures are much more onerous for business combinations than for asset acquisitions.
- ▶ Where the consideration is in the form of shares, IFRS 2 *Share-based payment* will apply for an asset acquisition, but not for a business combination.

These differences not only will affect the accounting as of the acquisition date, but will also affect future amortisation, depreciation and possible impairment. Accordingly, the conclusion as to whether a business has been acquired can have a significant effect on the companies’ reported financial positions and results of operations.

¹ The IASB have issued proposals to amend IAS 12 *Income Taxes* which eliminate the exemption for initial recognition of tax differences.



Definition of a business

Summary of revised definition

IFRS 3R defines a business as “an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.” It goes on to state that a business consists of three elements: inputs; processes applied to those inputs; and outputs. It also clarifies that to be considered a business, a set of activities and assets is required to have only inputs and processes, which together are or will be used to create outputs. The three elements of a business are defined as follows:

- ▶ *Input*: Any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it. Examples include non-current assets (such as intangible assets, or rights to use non-current assets), intellectual property, and the ability to obtain access to necessary materials or rights and employees.
- ▶ *Process*: Any system, standard, protocol, convention or rule that when applied to an input or inputs, creates or has the ability to create outputs. Examples include strategic management processes, operational processes and resource management processes.
- ▶ *Output*: The result of inputs and processes applied to those inputs that provide or have the ability to provide a

return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

The standard also notes that back-office processes (i.e., accounting, billing, payroll, etc.) typically are not processes used to create outputs. As such, the presence or exclusion of such processes generally will not affect the determination of whether an acquired set of activities and assets is considered a business. Furthermore, as noted above, outputs need not be present at the acquisition date for an integrated set of activities and assets to be defined as a business.

“Capable of” from the viewpoint of a market participant

As noted above, the revised definition of a business considers only whether the integrated set of assets and activities “is capable of being conducted and managed for the purpose of providing a return” to investors or other owners. Thus, an acquired set of activities and assets does not need to include all of the inputs or processes necessary to operate that set of activities and assets as a business (i.e., it does not need to be self-sustaining). If a market participant is capable of utilising the acquired set of activities and assets to produce outputs, for example, by integrating the acquired set with its own inputs and processes (essentially replacing the missing elements), then the acquired set of activities and assets might constitute a business. It is not necessarily relevant whether the seller historically had

operated the transferred set as a business, or whether the acquirer intends to operate the acquired set as a business. What is relevant is whether a market participant is capable of operating the acquired set of assets and activities as a business. Moreover, if the elements that are missing from the acquired set are not present with a market participant, but are easily replaced or replicated (i.e., the missing elements are “minor”), we believe a market participant would be capable of operating the acquired set in order to generate a return and the acquired set should be considered a business.

While the expanded definition of a business does not require that the acquired set of activities and assets contain all the inputs and processes necessary, we believe that, in most cases, the acquired set of activities and assets must have at least some inputs and processes in order to be considered a business. That is, if an acquirer obtains control of an input or set of inputs without any processes, in most cases, we do not believe the acquired input (s) would be considered a business, even if a market participant had all the processes necessary to operate the input (s) as a business.

Although the revised definition of a business was intended to improve consistency in the application of the definition of a business, the term “capable of” is sufficiently broad that significant judgment will continue to be required in determining whether an acquired set of activities and assets constitute a business.



Development stage enterprises

To date, the extent to which development stage entities (or start-ups) are businesses or not has not been clear. Under IFRS 3R, development stage enterprises may qualify as businesses because outputs are not required to be present at the acquisition date, and certain inputs and processes may not be required if either a market participant has access to the necessary inputs or processes or the missing elements are easily replaced. If so, acquisitions of such enterprises would be accounted for as business combinations. When evaluating development stage enterprises, various factors need to be considered to determine whether the transferred set of activities and assets is a business, including, but not limited to, the factors listed within IFRS 3R itself. Those factors include whether the acquired set of activities and assets in the development stage:

- ▶ Has begun its planned principal activities
- ▶ Has employees, intellectual property and other inputs and processes that could be applied to those inputs
- ▶ Is pursuing a plan to produce outputs
- ▶ Will be able to obtain access to customers that will purchase the outputs

This list of factors should not be considered a checklist; there is no minimum number of criteria that needs to be met when determining if a development stage

enterprise is a business. The primary consideration is whether the inputs and processes acquired, combined with the inputs and processes of a market participant (including those that are easily replaced or replicated, even if not present in a market participant), are capable of being conducted and managed to produce resulting outputs. While the facts and circumstances should be evaluated in each transaction, we believe that the further an acquired set of assets and activities is in its life cycle, the more difficult it will be to conclude a market participant is not capable of operating the acquired set as a business. For example, if the planned operations of an acquired set of assets and activities have commenced, we generally believe that the acquired activities and assets would represent a business. In addition, if the acquired activities and assets include employees and intellectual property such that it is capable of producing products, it is likely that the acquired activities and assets represent a business.

We believe that the application of this guidance will be particularly relevant for certain transactions in the life sciences industry since certain companies in that industry could be considered development stage enterprises. The application of this guidance to two possible transactions in the life sciences industry is illustrated in the following examples.



Life sciences example 1

Biotech A acquires all of the outstanding shares in Biotech B, which is a development stage company with a licence for a product candidate. Due to a loss of funding, Biotech B has no employees and no other assets. Neither clinical trials nor development are currently being performed. When additional funding is obtained, Biotech A plans to commence phase I clinical trials for the product candidate.

- ▶ *Input* - licence to product candidate
- ▶ *Processes* - none
- ▶ *Outputs* - none
- ▶ *Conclusion* - we do not believe Biotech A has acquired a business. While Biotech B has an input (licence), it lacks processes to apply to the licence in order to create outputs. Furthermore, Biotech B has no employees and is not pursuing a plan to produce outputs (no research and development is currently being performed).

Life sciences example 2

Biotech C acquires all of the outstanding shares in Biotech D, a development stage company that has a licence for a product candidate. Phase I clinical trials are currently being performed by Biotech D employees (one of whom founded Biotech D and discovered the product candidate). Biotech D's administrative and accounting functions are performed by a contract employee.

- ▶ *Inputs* - licence for product candidate and employees
- ▶ *Processes* - operational and management processes associated with the performance and supervision of the clinical trials
- ▶ *Output* - none
- ▶ *Conclusion* - we generally believe Biotech C has acquired a business because it has acquired inputs and processes. Furthermore, Biotech D has begun operations (development of the product candidate) and is pursuing a plan to produce outputs (i.e., a commercially developed product to be sold or licensed).

Presence of goodwill

Similar to the current standard, IFRS 3R contains a rebuttable presumption that if goodwill exists in the acquisition (i.e., if the aggregate value of an acquired set of activities and assets is greater than the value of the sum of identifiable tangible and intangible assets acquired), the acquisition is a business. For example, if the total fair

value of an acquired set of activities and assets is \$15 million and the fair value of the net identifiable assets in that set is only \$10 million, the existence of value in excess of the fair value of identifiable assets creates a presumption that the acquired set is a business. However, care should be exercised to ensure that all of the identifiable net assets have been identified and measured appropriately.

While the absence of goodwill may be an indicator that the acquired activities and assets do not represent a business, it is not presumptive. An acquisition of a business may involve a "bargain purchase" in which the new bases of the net identifiable assets are actually greater than the fair value of the entity as a whole.

Application of the definition of a business

In determining whether acquired assets and activities are a business, we believe the acquirer should first identify the elements acquired; that is, the inputs, processes and outputs. If outputs are not included in the acquired set, an assessment must be made as to whether the acquired activities and assets include inputs and processes that are capable of producing some form of return to its investors, owners, members or participants (the "owners"). If some inputs and processes are omitted from the acquired activities and assets such that the acquired set is not capable of providing some form of return to its owners, the acquirer must assess whether the missing inputs and processes would preclude a market participant from operating the acquired activities to earn a return. If a market participant that, in many cases, would be a competitor of the acquirer, were to have the missing inputs or processes, or could easily replace or replicate the missing inputs and processes (i.e., the missing elements are minor), the acquired set is likely a business. However, if the acquired set has no processes (e.g., only assets, and no activities, were acquired), the acquired set in most cases would not constitute a business. All of the specific facts and circumstances must be considered in applying this highly subjective judgment.

The application of this guidance to certain transactions in the extractive industries is illustrated in the following examples.



Extractive example 1

E&P Co. A (an oil and gas exploration and production company) acquires a mineral interest from E&P Co. B, on which it intends to perform exploration activities to determine if reserves exist. The mineral interest is an unproven property and there have been no exploration activities performed on the property.

- ▶ *Inputs* - mineral interest
- ▶ *Processes* - none
- ▶ *Outputs* - none
- ▶ *Conclusion* - we do not believe E&P Co. A acquired a business. While E&P Co. A acquired an input (mineral interest), it did not acquire any processes. Whether or not a market participant has the necessary processes in place to operate the input as a business is not relevant to the determination of whether the acquired set is a business because no processes were acquired from E&P Co. B.

Extractive example 2

E&P Co. A acquires a property similar to that in Example 1 above, except that oil and gas production activities are in place. The target's employees are not part of the transferred set; E&P Co. A will take over the operations by using its own employees.

- ▶ *Inputs* - oil and gas reserves
- ▶ *Processes* - operational processes associated with oil and gas production
- ▶ *Outputs* - revenues from oil and gas production
- ▶ *Conclusion* - we generally believe E&P Co. A acquired a business. The acquired set has all three components of a business (inputs, processes and outputs) and is capable of providing a return to its owners. Although the employees are not being transferred to the acquirer, a market participant would generally be able to produce outputs by: (1) supplying the employees necessary to continue production; and (2) integrating the business with its own operations while continuing to produce outputs.



In the real estate industry, IAS 40 *Investment Property* may help in making this assessment. IAS 40 notes that where ancillary processes exist connected to an investment property, and they are insignificant to the overall arrangement, this will not detract from the classification of the asset as investment property, rather than an asset with processes. Therefore, where only some processes are transferred, IAS 40 would lead to an assessment as to how significant the processes are relative to the processes needed for the set of assets and activities to be a real estate business.

Real estate example 1

Company A acquires land and a vacant building from Company B. No processes, other assets or employees (for example, leases and other contracts, maintenance or security personnel, or a leasing office) are acquired in the transaction.

- ▶ *Inputs* - land and vacant building
- ▶ *Processes* - none
- ▶ *Outputs* - none
- ▶ *Conclusion* - we do not believe Company A has acquired a business. While Company A acquired inputs (land and a vacant building), it did not acquire any processes. Whether or not a market participant has the necessary processes in place to operate the inputs as a business is not relevant to the determination of whether the acquired set is a business, because no processes were acquired from Company B.

Real estate example 2

Company A acquires an operating hotel, the hotel's employees, the franchise agreement, inventory, reservations system and all "back office" operations.

- ▶ *Inputs* - non-current assets, franchise agreement and employees
- ▶ *Processes* - operational and resource management processes associated with operating the hotel
- ▶ *Outputs* - revenues from operating the hotel
- ▶ *Conclusion* - we generally believe Company A has acquired a business. The acquired set has all three components of a business (inputs, processes and outputs) and is capable of providing a return to its owners.

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