Hong Kong Institute of Certified Public Accountants
香港會計師公會

MEMBERS' HANDBOOK

Update No. 224

(Issued 18 January 2019)

This Update relates to the issuance of Definition of a Business (Amendments to HKFRS 3 *Business Combinations*). An entity shall apply these amendments to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2020 and to asset acquisitions that occur on or after the beginning of that period.

Earlier application of these amendments is permitted, including in annual reporting periods beginning before 18 January 2019 (the date of issuance of these amendments). If an entity applies these amendments for an earlier period, it shall disclose that fact.

Retrospective application of the amendments to earlier transactions is not required because:
(i) it is unlikely to provide useful information to users of financial statements;
(ii) it could have been costly; and
(iii) it could have been impracticable if hindsight were to be needed.
Nevertheless, retrospective application was not prohibited because there may be instances when it would provide useful information and because when it is used it would not deprive users of useful information.

Document Reference and Title	***Instructions***	***Explanations***
VOLUME II		
Contents of Volume II	Discard existing pages i-ii & replace with revised pages i-ii.	Revised contents page
HONG KONG FINANCIAL REPORTING STANDARDS (HKFRS)		
HKFRS 3 (Revised) *Business Combinations*	Replace the cover page and pages 1A, 3 and 4 with revised cover page and pages 1A, 3 and 4. Insert pages 43-47 after page 42.	The amendments clarify the definition of a business, with the objective of assisting entities to determine whether a transaction should be accounted for as a business combination or as an asset acquisition.
HKFRS 3 (Revised) *Business Combinations* (Basis for Conclusions)	Replace the cover page and page 5 with revised cover page and page 5. Insert pages 98-105 after page 97.	
HKFRS 3 (Revised) *Business Combinations* (Illustrative Examples)	Replace the cover page, pages 2 and 21 with revised cover page and pages 2 and 21. Insert pages 21A-21K after page 21.	

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MEMBERS' HANDBOOK
CONTENTS OF VOLUME II

(Updated to January 2019)

HKFRS 3 (Revised)
Revised ~~September 2018~~January 2019

Effective for annual periods
beginning on or after 1 July 2009

Hong Kong Financial Reporting Standard 3 (Revised)

Business Combinations

Hong Kong Institute of
Certified Public Accountants
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Hong Kong Financial Reporting Standard 3 *Business Combinations* (HKFRS 3) is set out in paragraphs 1 – 68 and Appendices A – C and E. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the HKFRS. HKFRS 3 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

This revised Standard was issued in March 2008. It supersedes HKFRS 3 issued in 2004, as amended in 2005 and 2007.

Appendix E
Definition of a Business (Amendments to HKFRS 3 *Business Combinations*)

The following sets out amendments required for this Standard resulting from amendments to HKFRS 3 that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Standard and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

Paragraph 3, the definition of the term 'business' in Appendix A and paragraphs B7–B9, B11 and B12 are amended. Paragraphs 64P, B7A–B7C, B8A and B12A–B12D, and headings above paragraphs B7A, B8 and B12, are added. Paragraph B10 is deleted. New text is underlined and deleted text is struck through.

Identifying a business combination

3 **An entity shall determine whether a transaction or other event is a business combination by applying the definition in this HKFRS, which requires that the assets acquired and liabilities assumed constitute a business. If the assets acquired are not a business, the reporting entity shall account for the transaction or other event as an asset acquisition. Paragraphs B5–~~B12~~B12D provide guidance on identifying a business combination and the definition of a business.**

Effective date and transition

Effective date

...

64P *Definition of a Business*, issued in January 2019, added paragraphs B7A–B7C, B8A and B12A–B12D, amended the definition of the term 'business' in Appendix A, amended paragraphs 3, B7–B9, B11 and B12 and deleted paragraph B10. An entity shall apply these amendments to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2020 and to asset acquisitions that occur on or after the beginning of that period. Earlier application of these amendments is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact.

Appendix A

Defined terms

...

business An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities ~~a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants~~.

Definition of a business (application of paragraph 3)

B7 A business consists of inputs and processes applied to those inputs that have the ability to ~~create~~ contribute to the creation of outputs. ~~Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business.~~ The three elements of a business are defined as follows (see paragraphs B8–B12D for guidance on the elements of a business):

(a) **Input:** Any economic resource that creates outputs, or has the ability to ~~create,~~ contribute to the creation of outputs, when one or more processes are applied to it. Examples include non-current assets (including intangible assets or rights to use non-current assets), intellectual property, the ability to obtain access to necessary materials or rights and employees.

(b) **Process:** Any system, standard, protocol, convention or rule that, when applied to an input or inputs, creates outputs or has the ability to ~~create~~ contribute to the creation of outputs. Examples include strategic management processes, operational processes and resource management processes. These processes typically are documented, but 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. (Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs.)

(c) **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~~ goods or services to customers, generate investment income (such as dividends or interest) or generate other income from ordinary activities.

Optional test to identify concentration of fair value

B7A Paragraph B7B sets out an optional test (the concentration test) to permit a simplified assessment of whether an acquired set of activities and assets is not a business. An entity may elect to apply, or not apply, the test. An entity may make such an election separately for each transaction or other event. The concentration test has the following consequences:

(a) if the concentration test is met, the set of activities and assets is determined not to be a business and no further assessment is needed.

(b) if the concentration test is not met, or if the entity elects not to apply the test, the entity shall then perform the assessment set out in paragraphs B8–B12D.

B7B The concentration test is met if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. For the concentration test:

(a) gross assets acquired shall exclude cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities.

(b) the fair value of the gross assets acquired shall include any consideration transferred (plus the fair value of any non-controlling interest and the fair value of any previously held interest) in excess of the fair value of net identifiable assets acquired. The fair value of the gross assets acquired may normally be determined as the total obtained by adding the fair value of the consideration transferred (plus the fair value of any non-controlling interest and the fair value of any previously held interest) to the fair value of the liabilities assumed (other than deferred tax liabilities), and then excluding the items identified in subparagraph (a). However, if the fair value of the gross assets acquired is more than that total, a more precise calculation may sometimes be needed.

(c) a single identifiable asset shall include any asset or group of assets that would be recognised and measured as a single identifiable asset in a business combination.

(d) if a tangible asset is attached to, and cannot be physically removed and used separately from, another tangible asset (or from an underlying asset subject to a lease, as defined in HKFRS 16 *Leases*), without incurring significant cost, or significant diminution in utility or fair value to either asset (for example, land and buildings), those assets shall be considered a single identifiable asset.

(e) when assessing whether assets are similar, an entity shall consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets (that is, the risk characteristics).

(f) the following shall not be considered similar assets:

(i) a tangible asset and an intangible asset;

(ii) tangible assets in different classes (for example, inventory, manufacturing equipment and automobiles) unless they are considered a single identifiable asset in accordance with the criterion in subparagraph (d);

(iii) identifiable intangible assets in different classes (for example, brand names, licences and intangible assets under development);

(iv) a financial asset and a non-financial asset;

(v) financial assets in different classes (for example, accounts receivable and investments in equity instruments); and

(vi) identifiable assets that are within the same class of asset but have significantly different risk characteristics.

B7C The requirements in paragraph B7B do not modify the guidance on similar assets in HKAS 38 *Intangible Assets*; nor do they modify the meaning of the term ‘class’ in HKAS 16 *Property, Plant and Equipment*, HKAS 38 and HKFRS 7 *Financial Instruments: Disclosures*.

Elements of a business

B8 Although businesses usually have outputs, outputs are not required for an integrated set of activities and assets to qualify as a business. To be capable of being conducted and managed for the ~~purposes defined~~ purpose identified in the definition of a business, 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~~. ~~However, a~~ A business need not include all of the inputs or processes that the seller used in operating that business~~ if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes~~. However, to be considered a business, an integrated set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output. Paragraphs B12–B12D specify how to assess whether a process is substantive.

B8A If an acquired set of activities and assets has outputs, continuation of revenue does not on its own indicate that both an input and a substantive process have been acquired.

B9 The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities. Furthermore, an acquired set of activities and assets that is not a business might have liabilities.

B10 ~~An integrated set of activities and assets in the development stage might not have outputs. If not, the acquirer should consider other factors to determine whether the set is a business. Those factors include, but are not limited to, whether the set:~~

~~(a) has begun planned principal activities;~~

~~(b) has employees, intellectual property and other inputs and processes that could be applied to those inputs;~~

~~(c) is pursuing a plan to produce outputs; and~~

~~(d) will be able to obtain access to customers that will purchase the outputs.~~

~~Not all of those factors need to be present for a particular integrated set of activities and assets in the development stage to qualify as a business.~~ [Deleted]

B11 Determining whether a particular set of activities and assets ~~and activities~~ is a business ~~should~~ shall be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Thus, in evaluating whether a particular set is a business, it is not relevant whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business.

Assessing whether an acquired process is substantive

B12 ~~In the absence of evidence to the contrary, a particular set of assets and activities in which goodwill is present shall be presumed to be a business. However, a business need not have goodwill.~~ Paragraphs B12A–B12D explain how to assess whether an acquired process is substantive if the acquired set of activities and assets does not have outputs (paragraph B12B) and if it does have outputs (paragraph B12C).

B12A An example of an acquired set of activities and assets that does not have outputs at the acquisition date is an early-stage entity that has not started generating revenue. Moreover, if an acquired set of activities and assets was generating revenue at the acquisition date, it is considered to have outputs at that date, even if subsequently it will no longer generate revenue from external customers, for example because it will be integrated by the acquirer.

B12B If a set of activities and assets does not have outputs at the acquisition date, an acquired process (or group of processes) shall be considered substantive only if:

(a) it is critical to the ability to develop or convert an acquired input or inputs into outputs; and

(b) the inputs acquired include both an organised workforce that has the necessary skills, knowledge, or experience to perform that process (or group of processes) and other inputs that the organised workforce could develop or convert into outputs. Those other inputs could include:

(i) intellectual property that could be used to develop a good or service;

(ii) other economic resources that could be developed to create outputs; or

(iii) rights to obtain access to necessary materials or rights that enable the creation of future outputs.

Examples of the inputs mentioned in subparagraphs (b)(i)–(iii) include technology, in-process research and development projects, real estate and mineral interests.

B12C If a set of activities and assets has outputs at the acquisition date, an acquired process (or group of processes) shall be considered substantive if, when applied to an acquired input or inputs, it:

(a) is critical to the ability to continue producing outputs, and the inputs acquired include an organised workforce with the necessary skills, knowledge, or experience to perform that process (or group of processes); or

(b) significantly contributes to the ability to continue producing outputs and:

(i) is considered unique or scarce; or

(ii) cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

B12D The following additional discussion supports both paragraphs B12B and B12C:

(a) an acquired contract is an input and not a substantive process. Nevertheless, an acquired contract, for example, a contract for outsourced property management or outsourced asset management, may give access to an organised workforce. An entity shall assess whether an organised workforce accessed through such a contract performs a substantive process that the entity controls, and thus has acquired. Factors to be considered in making that assessment include the duration of the contract and its renewal terms.

(b) difficulties in replacing an acquired organised workforce may indicate that the acquired organised workforce performs a process that is critical to the ability to create outputs.

(c) a process (or group of processes) is not critical if, for example, it is ancillary or minor within the context of all the processes required to create outputs.

Basis for Conclusions on

Hong Kong Financial Reporting Standard 3 (Revised)

Business Combinations

Hong Kong Institute of
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Appendix B

Definition of a Business (Amendments to the Basis for Conclusions on IFRS 3 *Business Combinations*)

This appendix contains amendments to Basis for Conclusions on IFRS 3 that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Basis for Conclusions and this appendix will be deleted.

After paragraph BC21, new headings and paragraphs BC21A–BC21AC are added.

Clarifying the definition of a business

BC21A Following a Post-implementation Review (PIR) of IFRS 3, the Board noted that many stakeholders had concerns about how to interpret and apply the definition of a business. Stakeholders indicated that these concerns arose for one or more of the following main reasons:

(a) IFRS 3 requires a fact-driven assessment that adopts the perspective of market participants and does not consider the business rationale, strategic considerations and objectives of the acquirer (see paragraph BC21G);

(b) some sets of activities and assets might have been considered a business from the perspective of particular market participants who could integrate the set in their processes. However, the same sets of activities and assets might not have been considered a business from the perspective of other market participants (see paragraphs BC21H–BC21I);

(c) the definition of a business used the wording ‘capable of being conducted and managed for the purpose of providing’ a return. That wording did not help in determining whether a transaction includes a business (see paragraphs BC21J–BC21K);

(d) it was difficult to assess:

(i) whether the processes acquired are sufficient to constitute one of the elements required for an acquired set of activities and assets to be a business, and whether any missing processes are so significant that the set is not a business; and

(ii) how to apply the definition of a business if the acquired set of activities and assets does not generate revenue (see paragraphs BC21L–BC21R); and

(e) the definition of a business was broad and IFRS 3 had no guidance identifying when an acquired set of activities and assets is not a business (see paragraphs BC21S–BC21AC).

BC21B To consider those concerns, the Board added to its agenda a project to clarify the definition of a business, with the objective of assisting entities to determine whether a transaction should be accounted for as a business combination or as an asset acquisition. In 2016 the Board published an exposure draft *Definition of a Business and Accounting for Previously Held Interests* (2016 Exposure Draft). The 2016 Exposure Draft attracted 80 comment letters. The Board reviewed those comment letters and consulted the Accounting Standards Advisory Forum (ASAF), the Capital Markets Advisory Committee and the Global Preparers Forum. In 2018 the Board issued *Definition of a Business* (2018 Amendments). In the 2018 Amendments, the Board:

(a) clarified that to be considered a business, an acquired set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs (see paragraph BC21F);

(b) removed the assessment of whether market participants are capable of replacing any missing inputs or processes and continuing to produce outputs (see paragraphs BC21H–BC21I);

(c) added guidance and illustrative examples to help entities assess whether a substantive process has been acquired (see paragraphs BC21L–BC21R);

(d) narrowed the definitions of a business and of outputs by focusing on goods and services provided to customers and by removing the reference to an ability to reduce costs (see paragraph BC21S);

(e) added an optional concentration test that permits a simplified assessment of whether an acquired set of activities and assets is not a business (see paragraphs BC21T–BC21AC); and

(f) decided that an entity is permitted but not required to apply the amendments to transactions that occurred before the effective date of the amendments. Retrospective application of the amendments to earlier transactions is not required because it is unlikely to provide useful information to users of financial statements, could have been costly and could have been impracticable if hindsight were to be needed. Retrospective application was not prohibited because there may be instances when it would provide useful information and because when it is used it would not deprive users of useful information.

BC21C The 2016 Exposure Draft also dealt with a second topic, accounting for previously held interests. The Board finalised its work on that topic, among others, in 2017 by issuing *Annual Improvements to IFRS Standards 2015–2017 Cycle*.

BC21D IFRS 3 is the result of a joint project between the Board and the FASB and it contained the same definition of a business as the definition in US GAAP. The PIR of IFRS 3 and a PIR of SFAS 141(R) identified similar difficulties in applying the definition of a business. Moreover, the FASB received feedback from many stakeholders that the definition of a business in US GAAP was, in practice, viewed as capturing a broader range of transactions than the identical definition in IFRS 3. Consequently, the FASB amended US GAAP in 2017 by issuing Accounting Standards Update No. 2017-01 *Clarifying the Definition of a Business* (FASB 2017 Amendments). The 2018 Amendments addressed the issues identified during the PIR of IFRS 3 and, though worded differently, are based on conclusions similar to those reached by the FASB. The Board concluded that its 2018 Amendments and the FASB 2017 Amendments could together be expected to lead to more consistency in applying the definition of a business across entities applying US GAAP and entities applying IFRS Standards.

BC21E The 2018 Amendments differ in some respects from the FASB 2017 Amendments. Before finalising the 2018 Amendments, the Board discussed those differences with ASAF. The differences are as follows:

(a) the concentration test set out in paragraphs B7A–B7B of IFRS 3 is optional. The corresponding test in the FASB 2017 Amendments is mandatory. The guidance on how to identify concentration of fair value is substantially the same, but the Board added confirmation of the calculations normally needed (see paragraph B7B(b)) and an illustrative example (Example I).

(b) the Board concluded that an acquired outsourcing contract may give access to an organised workforce that performs a substantive process, even if the acquired set of activities and assets has no outputs. In some cases, that may lead to a conclusion that a business was acquired. In contrast, the FASB concluded that when outputs are not present, a business has been acquired only if the acquired set includes an organised workforce made up of employees.

(c) the Board clarified in paragraph B12D that difficulties in replacing an organised workforce may indicate that the organised workforce performs a process that is critical to the ability to create outputs. The FASB 2017 Amendments do not include this clarification.

(d) the FASB 2017 Amendments include a statement that the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive. The Board did not include such a statement in the 2018 Amendments (see paragraph BC21R(d)).

(e) the Board clarified in paragraph B7(c) of IFRS 3 that the narrowed definition of outputs includes other income from ordinary activities. An example of such other income is income from contracts outside the scope of IFRS 15 *Revenue from Contracts with Customers*. The FASB expressed a similar view as an observation in its Basis for Conclusions.

(f) the Board aligned the definition of a business with the revised definition of outputs in paragraph B7(c) of IFRS 3. The FASB did not align the two definitions, but its definition of a business refers explicitly to supporting guidance, including guidance on outputs.

Minimum requirements to be a business

BC21F The existence of a process (or processes) is what distinguishes a business from a set of activities and assets that is not a business. Consequently, the Board decided that to be considered a business, an acquired set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. The Board incorporated this requirement in paragraph B8. To clarify that a business can exist without including all of the inputs and processes needed to create outputs, the Board replaced the term 'ability to create outputs' with 'ability to contribute to the creation of outputs' in paragraph B7 of IFRS 3.

Market participant's perspective

BC21G Paragraph B11 of IFRS 3 adopts a market participant's perspective in determining whether an acquired set of activities and assets is a business. Some participants in the PIR of IFRS 3 noted that adopting that perspective requires a fact-driven assessment that does not consider the business rationale, strategic considerations and objectives of the acquirer. They expressed concerns that excluding those factors would not result in the most useful information for users of financial statements. Nevertheless, the Board concluded that the assessment should continue to be made from a market participant's perspective and to be driven by facts that indicate the current state and condition of what has been acquired, rather than by considering what the acquirer might intend to do with the acquired set of activities and assets. Basing this determination on facts, rather than on the intentions of the acquirer, helps to prevent similar transactions being accounted for differently. In the Board's view, bringing the business rationale, strategic considerations and objectives of the acquirer into the determination would have made the determination more subjective and thus would have increased diversity in practice. Consequently, the Board did not change paragraph B11 in this regard.

Market participant's ability to replace missing elements

BC21H Before the 2018 Amendments, paragraph B8 of IFRS 3 stated that a business need not include all of the inputs or processes that the seller used in operating that business 'if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes'. Many participants in the PIR of IFRS 3 stated that it can be challenging to assess whether market participants are capable of performing such an integration, especially if only some market participants are capable of performing such an integration.

BC21I In the light of those comments, the Board decided to base the assessment on what has been acquired in its current state and condition, rather than on whether market participants would be capable of replacing any missing inputs or processes, for example by integrating the acquired activities and assets. Therefore, the Board deleted the reference to such integration. Instead, as discussed in paragraph BC21F, the 2018 Amendments focus on whether acquired inputs and acquired substantive processes together significantly contribute to the ability to create outputs.

The term 'capable of' in the definition of a business

BC21J The definition of a business includes the phrase 'capable of being conducted and managed for the purpose of providing' a return. Many participants in the PIR indicated that this phrase was too broad in scope to be helpful in distinguishing businesses from assets. However, the Board concluded that it was not necessary to change or clarify this phrase because the 2018 Amendments:

(a) removed the assessment of whether market participants are capable of integrating the acquired activities and assets;

(b) clarified that the acquired processes need to be substantive;

(c) narrowed the definition of output; and

(d) added more robust guidance and illustrative examples supporting various aspects of the definition.

BC21K The Board considered whether additional guidance was needed regarding the acquisition of suppliers. In some cases, the acquirer integrates an acquired business with the result that it no longer generates revenue. For example, an entity may acquire a supplier and subsequently consume all the output from the supplier. The acquired inputs and processes are still 'capable of' generating revenue at the acquisition date and so could qualify as a business, if the criteria in paragraph B12C are met. The Board concluded that this outcome was appropriate because the assessment focuses on what the acquirer acquired, not on what the acquirer intends to do with what it acquired. Accordingly, the Board retained the term 'capable of' as the basis for assessment.

Assessing whether an acquired process is substantive

BC21L Many participants in the PIR of IFRS 3 stated that it is difficult to assess:

(a) whether the processes acquired are sufficient to constitute one of the elements required for an acquired set of activities and assets to be a business;

(b) whether any processes missing from that set are so significant that the set is not a business; and

(c) how to apply the definition of a business when the acquired set of assets does not generate revenue.

BC21M To address these concerns, the 2018 Amendments added guidance to help entities to assess whether an acquired process is substantive. That guidance seeks more persuasive evidence when there are no outputs because the existence of outputs already provides some evidence that the acquired set of activities and assets is a business. In particular, if the set has no outputs at the acquisition date, the inputs acquired must include:

(a) an organised workforce that meets specified criteria (see paragraphs BC21N–BC21P); and

(b) other inputs that the organised workforce could develop or convert into outputs (see paragraph BC21Q)

BC21N The Board concluded that the presence of an organised workforce is an indicator of a substantive process. Consequently, the Board decided that, except in limited circumstances, an organised workforce is required in order to conclude that the set of activities and assets is a business. The limited circumstances are when the acquired set both:

(a) has outputs; and

(b) includes a process (or a group of processes) that is unique or scarce, or cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs. The Board concluded that such processes are usually valuable and that this would often indicate that the processes are substantive, even if no organised workforce is acquired.

BC21O The Board concluded that although an organised workforce is an input to a business, it is not in itself a business. To conclude otherwise would mean that hiring a skilled employee without acquiring any other inputs could be considered to be acquiring a business. The Board decided that such an outcome would be inconsistent with the definition of a business.

BC21P Although the Board concluded that an organised workforce is an input, paragraph B7(b) indicates 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. The Board concluded that this is the case even if the processes are not documented. The Board inserted the phrase ‘intellectual capacity’ to provide clarity.

BC21Q For an acquired set of activities and assets to be considered a business if the set has no outputs, the Board concluded that the set should include not only a substantive process but also both an organised workforce and other inputs that the acquired organised workforce could develop or convert into outputs. Entities will need to evaluate the nature of those inputs to assess whether that process is substantive. The Board observed that many entities in the development stage will meet this criterion because technology, intellectual property, or other assets are being developed into a good or service. Conversely, if a set is producing outputs at the acquisition date, the set already contains inputs that are being converted into outputs, and, therefore, there is no need to consider specifically the type of inputs to which the acquired process is applied.

BC21R In finalising the 2018 Amendments, the Board also:

(a) specified in paragraph B12D(a) that an acquired contract is not a substantive process, in order to clarify that a contract that provides a continuing revenue stream (eg a lease contract) is not itself a process.

(b) clarified in paragraph B12D(a) that an acquired outsourcing agreement may give access to an organised workforce and that an entity should assess whether an organised workforce accessed through an outsourcing arrangement performs a substantive process that the entity controls, and thus has acquired. The Board added this paragraph because some IFRS Interpretations Committee members observed that IFRS 3 did not provide guidance on whether an outsourced process should be considered in assessing whether a set of activities and assets is a business.

(c) clarified in paragraph B12D(b) that difficulties in replacing an acquired organised workforce may indicate that the organised workforce performs a process that is critical to the ability to create outputs, because the Board expected that it would normally be more difficult to replace a workforce that performs a critical process than to replace a workforce that performs, for example, an ancillary process. The Board provided this indicator because some respondents to the 2016 Exposure Draft commented that the proposed guidance on substantive processes would require too much judgement.

(d) removed the presumption, proposed in the 2016 Exposure Draft, that the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive. Responses to the 2016 Exposure Draft showed that this proposal created more confusion than clarity. For example, some respondents were unclear whether this proposal referred to 'core goodwill' that is economically present in a business, or to the accounting measurement of goodwill that is determined in accounting for business combinations. Some respondents wondered whether this proposal would, in effect, force entities to apply business combination accounting to measure goodwill in order to assess whether what was acquired was in fact a business.

(e) deleted paragraph B10 of IFRS 3, which described factors to consider when assessing an integrated set of activities and assets in the development stage. The Board deleted that paragraph because the 2018 Amendments provide a more general discussion of acquired sets of activities and assets that do not have outputs.

(f) added illustrative examples in paragraphs IE73–IE123 to assist with the interpretation of what is considered a business. The draft illustrative examples in the 2016 Exposure Draft also included an example on the acquisition of oil and gas operations. To be consistent with the FASB 2017 Amendments, the Board did not include that example in the 2018 Amendments.

Narrowed definition of outputs

BC21S In the 2018 Amendments, the Board narrowed the definition of outputs to focus on goods and services provided to customers, investment returns and other income from ordinary activities and to exclude returns in the form of lower costs, and other economic benefits provided directly to investors or other owners, members, or participants. The Board also amended the definition of a business to make it consistent with the narrowed definition of outputs. The Board made these changes because:

(a) IFRS 15 *Revenue from Contracts with Customers* focuses on goods or services that are an output of an entity's ordinary activities. Nevertheless, because not all businesses have revenue within the scope of IFRS 15, the revised definition also includes outputs that are investment income or other income from ordinary activities.

(b) the previous definition of outputs referred to lower costs and economic benefits provided directly to investors. This reference did not help to distinguish between an asset and a business, because it confused motives for acquiring an asset with the characteristics of the activities and assets acquired. Many asset acquisitions (for example, the purchase of new manufacturing equipment) may be made with the motive of lowering costs but may not involve acquiring a substantive process.

Concentration test

BC21T Many participants in the PIR of IFRS 3 noted that applying the definition of a business involves significant judgements and that IFRS 3 provided little or no guidance that identifies situations in which an acquired set of activities and assets is not a business. To address these concerns, in the 2018 Amendments the Board added a concentration test that is designed to reduce cost and complexity by avoiding the need for a detailed assessment in some circumstances. If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset, or group of similar identifiable assets, the concentration test is met and the set of activities and assets is considered not to be a business. If the concentration test is met, no further assessment is needed.

BC21U The Board designed the concentration test with the aim of making it easy to understand and—in some straightforward cases that are easy to explain—simple to operate and less costly than applying the detailed assessment otherwise required by paragraphs B8–B12D. To target that aim, the concentration test focuses on a single identifiable asset or a single group of similar identifiable assets. The Board did not expect entities to carry out detailed calculations to apply the test, because detailed calculations would have frustrated the purpose of the test, which is to permit a simplified assessment. In addition, the Board wanted the test to have the same outcome in most circumstances as the detailed assessment and wanted to minimise the risk that the outcome of applying the concentration test could deprive users of financial statements of useful information.

BC21V To confirm that the Board did not expect detailed calculations, paragraph B7B(b) clarifies how the fair value of the gross assets acquired may normally be determined by reference to the fair value of the consideration transferred. In finalising the 2018 Amendments, the Board added an illustrative example showing that calculation (Example I).

BC21W The Board concluded that whether a set of activities and assets includes a substantive process does not depend on how the set is financed. Consequently, the concentration test is based on the gross assets acquired, not on net assets. Thus, the existence of debt (for example, a mortgage loan financing a building) or other liabilities does not alter the conclusion on whether an acquisition is a business combination. In addition, in response to requests from respondents, the Board specified, in finalising the 2018 Amendments, that the gross assets considered in the concentration test exclude cash and cash equivalents acquired, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. These exclusions were made because cash acquired, and the tax base of the assets and liabilities acquired, are independent of whether the acquired set of activities and assets includes a substantive process.

BC21X In finalising the 2018 Amendments, the Board made the concentration test optional. This change enables entities to assess whether they have acquired a substantive process when, for example, such an assessment would be more efficient than applying the concentration test, or would result in a conclusion that more faithfully represents the economics of a particular transaction. In line with the purpose of the concentration test, the 2018 Amendments:

(a) specify that the election to carry out that test is available transaction by transaction; and

(b) do not prohibit an entity from carrying out the detailed assessment required by paragraphs B8–B12D if the entity has carried out the concentration test and concluded that the acquired set of activities and assets is not a business. The Board decided that such a prohibition was unnecessary, because if an entity intended to disregard the outcome of the concentration test, it could have elected not to apply it.

BC21Y In making the concentration test optional, the Board considered the accounting consequences that would occur if, when applied to a particular transaction, the concentration test does not achieve the same outcome as the detailed assessment otherwise required by paragraphs B8–B12D. The concentration test identifies some transactions as an asset acquisition. For all other transactions, the entity must go on to perform the detailed assessment. The concentration test never determines that a transaction is a business combination.

BC21Z In theory, the concentration test might sometimes identify a transaction as an asset acquisition when the detailed assessment would identify it as a business combination. That outcome would be a false positive. The Board designed the concentration test to minimise the risk that a false positive could deprive users of financial statements of useful information. A false positive has two consequences:

(a) the entity fails to recognise 'core goodwill' that is economically present in a business combination but is not present in an asset acquisition.* Nevertheless, if substantially all of the fair value of the gross assets acquired (including core goodwill) is concentrated in a single identifiable asset (or a group of similar identifiable assets), the fair value of the core goodwill cannot be a substantial part of the total fair value of the gross assets acquired. Thus, information about the value of that core goodwill is unlikely to be material. Moreover, if the fair value of the processes acquired is not significant, the detailed assessment required by paragraphs B8–B12D would be unlikely to conclude that the processes are substantive.

(b) there are some other differences between the accounting required for a business combination and the accounting required for an asset acquisition, including differences relating to deferred tax, contingent consideration, acquisition-related costs, and gains on bargain purchases. Those differences in accounting requirements are not driven by differences between the economics of a business combination and the economics of an asset acquisition. Therefore, the Board did not expect a false positive to result in a loss of information about the economics of a business combination.

BC21AA The concentration test might not identify an asset acquisition that would be identified by the detailed assessment required by paragraphs B8–B12D. That outcome would be a false negative. An entity is required to carry out the detailed assessment in such a case and is expected to reach the same conclusion as if it had not applied the concentration test. Thus, a false negative has no accounting consequences.

BC21AB In finalising the 2018 Amendments, the Board also clarified some aspects of the guidance on a single identifiable asset and on similar identifiable assets (see paragraphs B7B(c)–(f) and B7C).

BC21AC In finalising the 2018 Amendments, the Board did not:

(a) make the concentration test an indicator, rather than determinative. Such a change would have been inconsistent with the objective of reducing the costs of applying IFRS 3 by providing a test that is designed to be simple in some straightforward cases that are easy to explain.

(b) provide further guidance on the term 'substantially all' because that term is already used in several IFRS Standards.

* Paragraphs BC313–BC318 describe 'core goodwill'. Those paragraphs also note that, because goodwill is measured as a residual, the carrying amount of goodwill includes several other factors as well as core goodwill.

Illustrative Examples and Comparison with SFAS 141(R)
Hong Kong Financial Reporting Standard 3 (Revised)

Business Combinations

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

CONTENTS

Appendix A
Amendments to guidance on other IFRSs

The following amendments to guidance on other IFRSs are necessary in order to ensure consistency with IFRS 3 (as revised in 2008) and the related amendments to other IFRSs. In the amended paragraphs, new text is underlined and deleted text is struck through.

* * *

The amendments contained in this appendix when this Guidance was issued have been incorporated into the text of the relevant Guidance.

Appendix B
Definition of a Business (Amendments to the Illustrative Examples accompanying IFRS 3 *Business Combinations)*

This appendix contains amendments to Illustrative Examples on IFRS 3 that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Illustrative Examples and this appendix will be deleted.

Paragraphs IE73–IE123 and their related headings are added.

Definition of a business

IE73 The examples in paragraphs IE74–IE123 illustrate application of the guidance in paragraphs B7–B12D on the definition of a business.

Example A—acquisition of real estate

Scenario 1—Background

IE74 An entity (Purchaser) purchases a portfolio of 10 single-family homes that each have an in-place lease. The fair value of the consideration paid is equal to the aggregate fair value of the 10 single-family homes acquired. Each single-family home includes the land, building and property improvements. Each home has a different floor area and interior design. The 10 single-family homes are located in the same area and the classes of customers (eg tenants) are similar. The risks associated with operating in the real estate market of the homes acquired are not significantly different. No employees, other assets, processes or other activities are transferred.

Scenario 1—Application of requirements

IE75 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) each single-family home is considered a single identifiable asset in accordance with paragraph B7B for the following reasons:

(i) the building and property improvements are attached to the land and cannot be removed without incurring significant cost; and

(ii) the building and the in-place lease are considered a single identifiable asset, because they would be recognised and measured as a single identifiable asset in a business combination (see paragraph B42).

(b) the group of 10 single-family homes is a group of similar identifiable assets because the assets (all single-family homes) are similar in nature and the risks associated with managing and creating outputs are not significantly different. This is because the types of homes and classes of customers are not significantly different.

(c) consequently, substantially all of the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets.

IE76 Therefore, Purchaser concludes that the acquired set of activities and assets is not a business.

Scenario 2—Background

IE77 Assume the same facts as in Scenario 1 except that Purchaser also purchases a multi-tenant corporate office park with six 10-storey office buildings that are fully leased. The additional set of activities and assets acquired includes the land, buildings, leases and contracts for outsourced cleaning, security and maintenance. No employees, other assets, other processes or other activities are transferred. The aggregate fair value associated with the office park is similar to the aggregate fair value associated with the 10 single-family homes. The processes performed through the contracts for outsourced cleaning and security are ancillary or minor within the context of all the processes required to create outputs.

Scenario 2—Application of requirements

IE78 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that the single-family homes and the office park are not similar identifiable assets, because the single-family homes and the office park differ significantly in the risks associated with operating the assets, obtaining tenants and managing tenants. In particular, the scale of operations and risks associated with the two classes of customers are significantly different. Consequently, the fair value of the gross assets acquired is not substantially all concentrated in a group of similar identifiable assets, because the fair value of the office park is similar to the aggregate fair value of the 10 single-family homes. Thus Purchaser assesses whether the set meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE79 The set of activities and assets has outputs because it generates revenue through the in-place leases. Consequently, Purchaser applies the criteria in paragraph B12C to determine whether any processes acquired are substantive.

IE80 Purchaser concludes that the criterion in paragraph B12C(a) is not met because:

(a) the set does not include an organised workforce; and

(b) Purchaser considers that the processes performed by the outsourced cleaning, security and maintenance personnel (the only processes acquired) are ancillary or minor within the context of all the processes required to create outputs (see paragraph B12D(c)) and, therefore, are not critical to the ability to continue producing outputs.

IE81 After considering the only processes acquired, those performed by the outsourced cleaning, security and maintenance personnel, Purchaser also concludes that the criteria in paragraph B12C(b) are not met. Either of the following reasons justifies that conclusion:

(a) the processes do not significantly contribute to the ability to continue producing outputs.

(b) the processes are readily accessible in the marketplace. Thus, they are not unique or scarce. In addition, they could be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

IE82 Because none of the criteria in paragraph B12C is met, Purchaser concludes that the acquired set of activities and assets is not a business.

Scenario 3—Background

IE83 Assume the same facts as in Scenario 2, except that the acquired set of activities and assets also includes the employees responsible for leasing, tenant management, and managing and supervising all operational processes.

Scenario 3—Application of requirements

IE84 Purchaser elects not to apply the optional concentration test set out in paragraph B7B and therefore assesses whether the set meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE85 The acquired set of activities and assets has outputs because it generates revenue through the in-place leases. Consequently, Purchaser applies the criteria in paragraph B12C.

IE86 Purchaser concludes that the criterion in paragraph B12C(a) is met because the set includes an organised workforce with the necessary skills, knowledge or experience to perform processes (ie leasing, tenant management, and managing and supervising the operational processes) that are substantive because they are critical to the ability to continue producing outputs when applied to the acquired inputs (ie the land, buildings and in-place leases). Furthermore, Purchaser concludes that the criterion in paragraph B8 is met because those substantive processes and inputs together significantly contribute to the ability to create output. Consequently, Purchaser concludes that the acquired set of activities and assets is a business.

Example B—acquisition of a drug candidate

Scenario 1—Background

IE87 An entity (Purchaser) purchases a legal entity that contains:

(a) the rights to an in-process research and development project that is developing a compound to treat diabetes and is in its final testing phase (Project 1). Project 1 includes the historical know-how, formula protocols, designs and procedures expected to be needed to complete the final testing phase.

(b) a contract that provides outsourced clinical trials. The contract is priced at current market rates and a number of vendors in the marketplace could provide the same services. Therefore, the fair value associated with this contract is nil. Purchaser has no option to renew the contract.

No employees, other assets, other processes or other activities are transferred.

Scenario 1—Application of requirements

IE88 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) Project 1 is a single identifiable asset because it would be recognised and measured as a single identifiable intangible asset in a business combination.

(b) because the acquired contract has a fair value of nil, substantially all of the fair value of the gross assets acquired is concentrated in Project 1.

IE89 Consequently, Purchaser concludes that the acquired set of activities and assets is not a business.

Scenario 2—Background

IE90 Assume the same facts as in Scenario 1 except that the acquired set of activities and assets also includes another in-process research and development project that is developing a compound to treat Alzheimer's disease and is in its final testing phase (Project 2). Project 2 includes the historical know-how, formula protocols, designs, and procedures expected to be needed to complete the final phase of testing. The fair value associated with Project 2 is similar to the fair value associated with Project 1. No employees, other assets, processes or other activities are transferred.

Scenario 2—Application of requirements

IE91 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) Project 1 and Project 2 are identifiable intangible assets that would each be recognised and measured as a separate identifiable asset in a business combination.

(b) Project 1 and Project 2 are not similar identifiable assets because significantly different risks are associated with managing and creating outputs from each asset. Each project has significantly different risks associated with developing, completing and marketing the compound to customers. The compounds are intended to treat significantly different medical conditions, and each project has a significantly different potential customer base.

(c) consequently, the fair value of the gross assets acquired is not substantially all concentrated in a single identifiable asset or group of similar identifiable assets. Therefore, Purchaser assesses whether the set meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE92 The acquired set of activities and assets does not have outputs because it has not started generating revenue. Thus, Purchaser applies the criteria in paragraph B12B. Purchaser concludes that those criteria are not met for the following reasons:

(a) the set does not include an organised workforce; and

(b) although the contract that provides outsourced clinical trials might give access to an organised workforce that has the necessary skills, knowledge or experience to perform processes needed to carry out the clinical trials, that organised workforce cannot develop or convert the inputs acquired by Purchaser into outputs. Successful clinical trials are a pre-condition for producing output, but carrying out those trials will not develop or convert the acquired inputs into outputs.

Consequently, Purchaser concludes that the acquired set of activities and assets is not a business.

Example C—acquisition of a biotech entity

Background

IE93 An entity (Purchaser) purchases a legal entity (Entity Biotech). Entity Biotech's operations include: research and development activities on several drug compounds that it is developing (in-process research and development projects); senior management and scientists who have the necessary skills, knowledge, or experience to perform research and development activities; and tangible assets (including a corporate headquarters, a research lab, and lab equipment). Entity Biotech does not yet have a marketable product and has not yet generated revenue. Each of the assets acquired has a similar fair value.

Application of requirements

IE94 It is evident that the fair value of the gross assets acquired is not substantially all concentrated in a single identifiable asset or group of similar identifiable assets. Thus, the optional concentration test set out in paragraph B7B would not be met. Consequently, Purchaser assesses whether the set meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE95 Purchaser first assesses whether it has acquired any processes. No process is documented. Nevertheless, the acquired organised workforce has proprietary knowledge of Biotech's ongoing projects and experience with them. Applying paragraph B7(b), Purchaser concludes that the intellectual capacity of the acquired organised workforce having the necessary skills and experience following rules and conventions provides the necessary processes that are capable of being applied to inputs to create outputs.

IE96 Purchaser next assesses whether the acquired processes are substantive. The set of activities and assets does not have outputs. Thus, Purchaser applies the criteria in paragraph B12B. Purchaser concludes that those criteria are met because:

(a) the acquired processes are critical to the ability to develop or convert the acquired inputs into outputs; and

(b) the inputs acquired include both:

   (i) an organised workforce that has the necessary skills, knowledge, or experience to perform the acquired processes; and

   (ii) other inputs that the organised workforce could develop or convert into outputs. Those inputs include the in-process research and development projects.

IE97 Finally, applying the criteria in paragraph B8, Purchaser concludes that the acquired substantive processes and the acquired inputs together significantly contribute to the ability to create output. Consequently, Purchaser concludes that the acquired set of activities and assets is a business.

Example D—acquisition of a television station

Background

IE98 An entity (Purchaser) purchases broadcasting assets from another entity (Seller). The acquired set of activities and assets includes only the communications licence, the broadcasting equipment and an office building. Each of the assets acquired has a similar fair value. Purchaser does not purchase the processes needed to broadcast programmes and it does not acquire any employees, other assets, other processes or other activities. Before the acquisition date, Seller stopped broadcasting using the set of activities and assets acquired by Purchaser.

Application of requirements

IE99 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) the broadcasting equipment and building are not a single identifiable asset because the equipment is not attached to the building and can be removed without significant cost or diminution in utility or fair value of either asset.

(b) the licence is an intangible asset, whereas the broadcasting equipment and building are tangible assets in different classes. Consequently, in accordance with paragraph B7B(f), the assets are not considered similar to each other.

(c) each of the single identifiable assets has similar fair value. Thus, the fair value of the gross assets acquired is not substantially all concentrated in a single identifiable asset or group of similar identifiable assets.

Consequently, Purchaser assesses whether the set of activities and assets meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE100 The set of activities and assets does not have outputs, because Seller has stopped broadcasting. Thus, Purchaser applies the criteria in paragraph B12B. The set does not include an organised workforce, so it does not meet those criteria. Consequently, Purchaser concludes that the acquired set of activities and assets is not a business.

Example E—acquisition of a closed manufacturing facility

Background

IE101 An entity (Purchaser) purchases a closed manufacturing facility—the land and the building—as well as the related equipment. The fair value of the equipment and the fair value of the facility are similar. To comply with local laws, Purchaser must take over the employees who worked in the facility. No other assets, processes or other activities are transferred. The acquired set of activities and assets stopped producing outputs before the acquisition date.

Application of requirements

IE102 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) the equipment and the facility are not a single identifiable asset because the equipment could be removed from the facility without significant cost or diminution in utility or fair value of either the equipment or the facility—the equipment is not attached to the facility and can be used in many other types of manufacturing facilities.

(b) the equipment and facility are not similar identifiable assets because they are in different classes of tangible assets.

(c) the fair values of the equipment and the facility are similar. Therefore, the fair value of the gross assets acquired is not substantially all concentrated in a single identifiable asset or group of similar identifiable assets.

Consequently, Purchaser assesses whether the set of activities and assets meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE103 The acquired set of activities and assets does not have outputs at the acquisition date because it stopped producing outputs before then. Consequently, Purchaser applies the criteria in paragraph B12B. The set includes an organised workforce that has the necessary skills, knowledge or experience to use the equipment, but it does not include another acquired input (such as intellectual property or inventories) that the organised workforce could develop or convert into outputs. The facility and the equipment cannot be developed or converted into outputs. Consequently, Purchaser concludes that the acquired set of activities and assets is not a business.

Example F—licence of distribution rights

Background

IE104 An entity (Purchaser) purchases from another entity (Seller) the exclusive sublicence to distribute Product X in a specified jurisdiction. Seller has the licence to distribute Product X worldwide. As part of this transaction, Purchaser also purchases the existing customer contracts in the jurisdiction and takes over a supply contract to purchase Product X from the producer at market rates. None of the identifiable assets acquired has a fair value that constitutes substantially all of the fair value of the gross assets acquired. No employees, other assets, processes, distribution capabilities or other activities are transferred.

Application of requirements

IE105 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) the identifiable assets that could be recognised in a business combination include the sublicence to distribute Product X, customer contracts and the supply contract;

(b) the sublicence and customer contracts are in different classes of intangible assets, so they are not similar identifiable assets; and

(c) consequently, the fair value of the gross assets acquired is not substantially all concentrated in a single identifiable asset or group of similar identifiable assets.

Consequently, Purchaser assesses whether the set of activities and assets meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE106 The set of activities and assets has outputs because at the acquisition date the licence was generating revenue from customers in the jurisdiction specified in the sublicence. Consequently, Purchaser applies the criteria in paragraph B12C. As explained in paragraph B12D(a), acquired contracts are an input and not a substantive process. Purchaser considers next whether the acquired supply contract provides access to an organised workforce that performs a substantive process. Because the supply contract is not providing a service that applies a process to another acquired input, Purchaser concludes that the substance of the supply contract is only that of buying Product X, without acquiring the organised workforce, processes and other inputs needed to produce Product X. Furthermore, the acquired sublicence is an input, not a process. Purchaser concludes that the set is not a business because it does not include an organised workforce and Purchaser has acquired no substantive process that could meet the criteria in paragraph B12C.

Example G—acquisition of brands

Background

IE107 Assume the same facts as in Example F, except that Purchaser purchases the worldwide rights to Product X, including all related intellectual property. The acquired set of activities and assets includes all customer contracts and customer relationships, finished goods inventories, marketing materials, customer incentive programmes, raw material supply contracts, specialised equipment specific to manufacturing Product X and documented manufacturing processes and protocols to produce Product X. No employees, other assets, other processes or other activities are transferred. None of the identifiable assets acquired has a fair value that constitutes substantially all of the fair value of the gross assets acquired.

Application of requirements

IE108 As noted in paragraphs IE105 and IE107, the fair value of the gross assets acquired is not substantially all concentrated in a single identifiable asset or group of similar identifiable assets. Thus, the optional concentration test set out in paragraph B7B would not be met. Consequently, Purchaser assesses whether the set of activities and assets meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE109 The set of activities and assets has outputs, so Purchaser applies the criteria in paragraph B12C. The set does not include an organised workforce and, therefore, does not meet the criterion in paragraph B12C(a). However, Purchaser concludes that the acquired manufacturing processes are substantive because, when applied to acquired inputs, such as the intellectual property, raw material supply contracts and specialised equipment, those processes significantly contribute to the ability to continue producing outputs and because they are unique to Product X. Consequently, the criterion in paragraph B12C(b) is met. Furthermore, Purchaser concludes that the criterion in paragraph B8 is met because those substantive processes and inputs together significantly contribute to the ability to create output. As a result, Purchaser concludes that the acquired set of activities and assets is a business.

Example H—acquisition of loan portfolio

Scenario 1—Background

IE110 An entity (Purchaser) purchases a loan portfolio from another entity (Seller). The portfolio consists of residential mortgage loans with terms, sizes and risk ratings that are not significantly different. No employees, other assets, processes or other activities are transferred.

Scenario 1—Application of requirements

IE111 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) the assets (residential mortgage loans) are similar in nature;

(b) the risks associated with managing and creating outputs are not significantly different because the terms, sizes and risk ratings of the loans are not significantly different;

(c) the acquired loans are similar assets; and

(d) consequently, substantially all of the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets.

Consequently, Purchaser concludes that the acquired set of activities and assets is not a business.

Scenario 2—Background

IE112 Assume the same facts as in Scenario 1 except that the portfolio of loans consists of commercial loans with terms, sizes and risk ratings that are significantly different. None of the acquired loans, and no group of loans with similar terms, sizes and risk ratings, has a fair value that constitutes substantially all of the fair value of the acquired portfolio. No employees, other assets, processes or other activities are transferred.

Scenario 2—Application of requirements

IE113 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) the assets (commercial loans) are similar in nature;

(b) the risks associated with managing and creating outputs from the loans are significantly different because the terms, sizes and risk ratings of the loans are significantly different;

(c) the acquired loans are not similar identifiable assets; and

(d) consequently, the fair value of the gross assets acquired is not substantially all concentrated in a group of similar identifiable assets.

Consequently, Purchaser assesses whether the set meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE114 The portfolio of loans has outputs because it generates interest income. Consequently, Purchaser applies the criteria in paragraph B12C. Acquired contracts are not a substantive process, as explained in paragraph B12D(a). Moreover, the acquired set of activities and assets does not include an organised workforce and there are no acquired processes that could meet the criteria in paragraph B12C(b). Consequently, Purchaser concludes that the acquired set of activities and assets is not a business.

Scenario 3—Background

IE115 Assume the same facts as in Scenario 2 but Purchaser also takes over the employees of Seller (such as brokers, vendors, and risk managers) who managed the credit risk of the portfolio and the relationship with the borrowers. The consideration transferred to Seller is significantly higher than the fair value of the acquired portfolio of loans.

Scenario 3—Application of requirements

IE116 As noted in paragraph IE113, the fair value of the gross assets acquired is not substantially all concentrated in a group of similar identifiable assets. Thus, the optional concentration test set out in paragraph B7B would not be met. Consequently, Purchaser assesses whether the set meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE117 The portfolio of loans has outputs because it generates interest income. Consequently, Purchaser applies the criteria in paragraph B12C and concludes that the criterion in paragraph B12C(a) is met because the set includes an organised workforce with the necessary skills, knowledge or experience to perform processes (customer relationship management and credit risk management) critical to the ability to continue producing outputs. Furthermore, Purchaser concludes that the criterion in paragraph B8 is met because those substantive processes and the acquired inputs (the portfolio of loans) together significantly contribute to the ability to create output. Consequently, Purchaser concludes that the acquired set is a business.

Example I—determining the fair value of the gross assets acquired

Background

IE118 An entity (Purchaser) holds a 20% interest in another entity (Entity A). At a subsequent date (the acquisition date), Purchaser acquires a further 50% interest in Entity A and obtains control of it. Entity A's assets and liabilities on the acquisition date are the following:

(a) a building with a fair value of CU500;

(b) an identifiable intangible asset with a fair value of CU400;

(c) cash and cash equivalents with a fair value of CU100;

(d) financial liabilities with a fair value of CU700; and

(e) deferred tax liabilities of CU160 arising from temporary differences associated with the building and the intangible asset.

IE119 Purchaser pays CU200 for the additional 50% interest in Entity A. Purchaser determines that at the acquisition date the fair value of Entity A is CU400, that the fair value of the non-controlling interest in Entity A is CU120 (30% x CU400) and that the fair value of the previously held interest is CU80 (20% x CU400).

Application of requirements

IE120 To perform the optional concentration test set out in paragraph B7B, Purchaser needs to determine the fair value of the gross assets acquired. Applying paragraph B7B, Purchaser determines that the fair value of the gross assets acquired is CU1,000, calculated as follows:

(a) the fair value of the building (CU500); plus

(b) the fair value of the identifiable intangible asset (CU400); plus

(c) the excess (CU100) of:

(i) the sum (CU400) of the consideration transferred (CU200), plus the fair value of the non-controlling interest (CU120), plus the fair value of the previously held interest (CU80); over

(ii) the fair value of the net identifiable assets acquired (CU300 = CU500 + CU400 + CU100 – CU700).

IE121 The excess referred to in paragraph IE120(c) is determined in a manner similar to the initial measurement of goodwill in accordance with paragraph 32 of IFRS 3. Including this amount in determining the fair value of the gross assets acquired means that the concentration test is based on an amount that is affected by the value of any substantive processes acquired.

IE122 The fair value of gross assets acquired is determined after making the following exclusions specified in paragraph B7B(a) of IFRS 3 for items that are independent of whether any substantive process was acquired:

(a) the fair value of the gross assets acquired does not include the fair value of the cash and cash equivalents acquired (CU100) and does not include deferred tax assets (nil in this example); and

(b) for the calculation specified in paragraph IE120(c)(ii), the deferred tax liability is not deducted in determining the fair value of the net assets acquired (CU300) and does not need to be determined. As a result, the excess (CU100) calculated by applying paragraph IE120(c) does not include goodwill resulting from the effects of deferred tax liabilities.

IE123 The fair value of the gross assets acquired (CU1,000) may also be determined as follows:

(a) the total (CU1,100) obtained by adding:

(i) the amount paid (CU200) (plus the fair value of the non-controlling interest (CU120) plus the fair value of the previously held interest (CU80)); to

(ii) the fair value of the liabilities assumed (other than deferred tax liabilities) (CU700); less

(b) the cash and cash equivalents acquired (CU100); less

(c) deferred tax assets acquired (nil in this example). In practice, it would be necessary to determine the amount of deferred tax assets to be excluded only if including the deferred tax assets could lead to the concentration test not being met.