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Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London
United Kingdom
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Dear Mr Hoogervorst

Exposure draft 2016/1 – Definition of a Business and Accounting for Previously Held Interests (Proposed amendments to IFRS 3 and IFRS 11)

Deloitte Touche Tohmatsu Limited is pleased to respond to the International Accounting Standards Board's (the IASB's) Exposure Draft *Definition of a Business and Accounting for Previously Held Interests (Proposed amendments to IFRS 3 and IFRS 11)* ('the exposure draft').

We welcome the IASB's initiative in addressing an issue (the application of the definition of a business) which, as evidenced by responses to the post-implementation review of IFRS 3, is currently a distinction that is difficult to apply in practice, inevitably leading to a degree of diversity in practice.

We support the introduction of a 'concentration test' as an effective means of excluding from the scope of business combination accounting a population of transactions (in, for example, the real estate, pharmaceutical and extractives industries) that are driven primarily by the acquisition of an asset but that, based on the current guidance in IFRS 3, sometimes fall into the definition of business combinations. However, to be operational we believe that this test needs to be refined, specifically in applying the idea of 'similar identifiable assets' as we believe that a purchase of a group of assets that differ in form but whose use and value is inextricably linked should be captured by the 'concentration test'.

More broadly, most of the pressure on determining whether an acquisition involves a business is due to the differences in accounting for acquisitions of assets and businesses. Hence, we recommend that the Board also seek to minimise or eliminate the accounting differences between business combinations and asset purchases (for example, the differing treatment of deferred tax and transaction costs and the currently unresolved question of accounting for contingent consideration for an asset purchase).

On the proposed amendments to IFRS 3 and IFRS 11 on obtaining control, or joint control, of a joint operation that constitutes a business, we agree with the specific amendments proposed but recommend that the issue of changes in stake be considered more broadly.

Our detailed responses to the questions in the invitation to comment are included in the Appendix to this letter.

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If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 20 7007 0884.

Yours sincerely

Veronica Poole
Global IFRS Leader

Appendix

Question 1
The Board is proposing to amend IFRS 3 to clarify the guidance on the definition of a business (see paragraphs B7–B12C and BC5–BC31). Do you agree with these proposed amendments to IFRS 3?

In particular, do you agree with the Board's conclusion that if substantially all the fair value of the gross assets acquired (i.e. the identifiable assets and non-identifiable assets) is concentrated in a single identifiable asset or group of similar identifiable assets, then the set of activities and assets is not a business (see paragraphs B11A–B11C)?

Why or why not? If not, what alternative would you propose, if any, and why?

We welcome the Board's initiative in providing additional clarity on the definition of a business as this is currently an area which causes difficulties in practice. More broadly, however, we note that the primary difference between accounting for a business combination and an asset purchase is often the recognition of deferred tax. This is particularly true in respect of the transactions most likely to be affected by a 'concentration test', such as acquisitions in real estate or the extractive industries. As evidenced by the IFRS Interpretations Committee's current discussions on recognition of deferred taxes when acquiring a single-asset entity that is not a business, this can result in 'day 2' gains or losses driven by application of the initial recognition exemption in IAS 12, rather than by any actual change in asset value.

Differences between business and asset acquisitions also arise in the capitalisation or otherwise of transaction costs and the treatment of contingent consideration (which, as evidenced by the IFRS Interpretations Committee's agenda decision in March 2016, remains unclear for transactions other than business combinations). The conceptual basis for these differences is unclear and there is a valid question of whether some, or all, such differences are necessary. We recommend that, following finalisation of the proposed amendments, the IASB seek to minimise or eliminate these differences.

Concentration of fair value of assets acquired
We agree that the 'concentration test' would provide a useful simplification, enabling a sizeable population of transactions motivated primarily by the acquisition of an asset (for example, in the real estate, pharmaceutical and extractives industries) to be excluded from the scope of business combination accounting. However, since as presented in the exposure draft such a test would be to some extent in the nature of a practical expedient, then depending on the comments received on the exposure draft it may worth the Board considering whether such a test would be better characterised as a rebuttable presumption rather than as a fixed rule.

In addition, we are concerned that as drafted certain aspects of the proposed amendments may not prove operational.

Primarily, we are concerned that the idea of 'similar identifiable assets' is not well defined and could, in some cases, give rise to counter-intuitive results. In terms of further explanation of how 'similar' should be interpreted in this context, the exposure draft provides only (in proposed paragraph B11C) examples of different classes of asset that should *not* be considered 'similar' and (in the proposed Illustrative Examples) examples of assets that are similar in most conceivable respects (e.g. a group of fully leased, 10-storey office buildings that are all fully leased and are all in the same corporate office park). It is, therefore, unclear how 'similar' should be assessed as the proposed amendments to Appendix B to IFRS 3 could be read as suggesting that being in the same class of asset is sufficient, whilst the proposed Illustrative Examples could be interpreted as applying a much higher threshold to assets being considered 'similar'. As a specific point, we believe that an example illustrating how 'similarity' should be applied to financial assets (for example, within a loan book or credit card portfolio) would be helpful.

In addition, we are concerned that a rule that two assets in different classes cannot be considered similar would exclude groups of assets that, while different in form, share risk characteristics and are inextricably linked in terms of their value and utilisation. For example:

- a physical asset and its tax attributes (resulting, if the asset's tax base exceeds its fair value, in recognition of a deferred tax asset if the transaction is considered a business combination);
- land and associated planning permission; or
- an oil pipeline or mine and a customer contract to take output only from that asset.

A purchase of any of these groups of assets alone is likely to be a transaction of the type we would see as appropriately qualifying for the simplification described in paragraph BC18 of the Basis for Conclusions on the exposure draft, but according to the wording in proposed paragraph B11C would seem to be excluded from the scope of the 'concentration test'.

Evaluation of whether an acquired process is substantive

We agree with the proposed narrowing of the definition of 'output' to focus on revenue rather than cost reduction and with the differentiation between acquirees with and without an organised workforce and with and without outputs as these are likely to provide some simplification and are consistent with the commonly understood notion of a 'business' as an entity involving people making sales. Although, as a point of detail, we note that the decision tree in proposed paragraph B8A could usefully be extended to reflect the extra step depending on whether the set has outputs or not.

However, we recommend that the reference to the presence of goodwill as an indicator that an acquiree constitutes a business be deleted as we do not believe it is consistent with the more detailed discussion of substantive processes in proposed paragraphs B12A-C. This test has limited conceptual merit. The determination of whether goodwill is present is, from a practical point of view, performed after the determination of whether a transaction is a business combination and its use as an indicator that an acquiree is a business is therefore circular. This is particularly evident in the acquisition of single-asset entities (for example, a wrapper company holding a single property) as the decision on whether a transaction is a business combination will then determine whether a deferred tax asset or liability is recognised. This distinction between accounting for a business combination compared to an asset acquisition is, for such transactions, often the primary factor which determines whether an excess of consideration over net assets acquired (i.e. calculated 'goodwill') exists.

In addition, factors other than the presence of 'goodwill' can affect this calculation – for example, the value of equity instruments delivered as consideration can be affected by a variety of factors unrelated to the transaction itself (for example, the share price of entities in the extractives industry is significantly affected by daily movements in commodity prices), meaning that 'goodwill' could be calculated due to a change in value between agreeing the number of equity instruments and the date of acquisition when there is, conceptually, no goodwill in the acquiree.

We are also concerned that the distinction between an input and a process remains unclear in some cases, particularly in the context of research and development. In-process research and development is noted as an input in proposed paragraph B12A, yet would typically involve a number of research personnel whose work would seem to constitute a process.

The application of proposed paragraph B12A to research is also likely to prove problematic as at that stage in a project it is typically unclear whether the intellectual property acquired "could be used to develop a good or service" (for example, it may be unclear at the date of acquiring intellectual property relating to a drug candidate whether that candidate is viable to develop into a commercial product), as such we believe guidance on the level of confidence over the project's viability should be provided.

Proposed illustrative examples
We believe the inclusion of illustrative examples is helpful, however as detailed below we believe that additional clarity would be helpful for a number of the transactions described.

- In each of Example A (acquisition of single-family homes), Example B (acquisition of a drug candidate) and Example H (acquisition of investment properties) it is stated that "no employees, other assets, or other activities are transferred". However, as in each of these examples the conclusion is reached that the acquiree is not a business because substantially all the fair value of gross assets is concentrated in one asset (or group of similar assets). Given the concentration test it proposed to be applied before any other analysis, whether there are or are not employees transferred does not, then, appear to be a relevant factor (albeit, in a different transaction with an organised workforce having significant value the conclusion on the concentration test may differ).
- The transaction described by Example D (acquisition of a manufacturing facility) is difficult to understand (particularly, what is meant by 'temporarily closed-down' and why a workforce is acquired with seemingly no work to perform). As noted in our response to Question 2 below, we recommend that the fuller description in the equivalent FASB Illustrative Example be used. Similarly, the reason why the television station acquired in Example C does not have outputs is clearer in the FASB example.

An analysis of a mine or oil field still in the pre-production phase would be more helpful than Example J (acquisition of oil and gas operations), particularly as such an operation might already include high-value equipment which might mean that the 'concentration test' does not apply (due to this equipment being in a different class of asset than the land or mining rights).

Question 2
The Board and the FASB reached substantially converged tentative conclusions on how to clarify and amend the definition of a business. However, the wording of the Board's proposals is not fully aligned with the FASB's proposals.

Do you have any comments regarding the differences in the proposals, including any differences in practice that could emerge as a result of the different wording?

We recommend that the Board and the FASB continue to work together to ensure that the wording of the revised guidance in IFRS 3 is as converged as is possible with its U.S. GAAP equivalent. Given there appear to be no conceptual differences between the boards in this area, it would be unfortunate if unintentional differences arose as a result of unnecessarily divergent wording.

In terms of the proposed revised wording in Appendix B to IFRS 3, we note the following:

- Proposed paragraphs B12A and B12B refer to an acquiree having outputs <u>at the acquisition date</u>, giving an example of generating revenues before the acquisition. Proposed paragraph 805-10-55-5B of the FASB ED, on the other hand, refers to "a continuation of revenue before and after the transaction". We believe that the idea of a continuation of activity (i.e. the continued generation of outputs) will be more operational than that of output at a specific point in time (for example, in circumstances similar to those described in Example D to the exposure draft, a temporary cessation of activity as at the date of acquisition could be interpreted as resulting in a conclusion that, under the IASB proposals, the acquiree is not a business) and that reference to a *continuation* of outputs (consistent with the FASB approach) would, therefore, be preferable.
- Proposed paragraph B7(b) adds the qualifier re "<u>the intellectual capacity of</u> an organised workforce", which is not included in the FASB ED. If this is to be added, we recommend that it be explained more fully (possibly in the terms used in paragraph BC24 of the Basis for Conclusions on the exposure draft of "the capacity of an organised workforce to perform a process even if the process is not documented) as in isolation it could suggest a different approach depending on the nature of the activities performed by a workforce.
- Proposed paragraph B12A states that "the set is a business <u>only</u> if it includes an organised workforce", in this respect proposed paragraph 805-55-5A of the FASB ED is less clear that an organised workforce is a necessary condition to be a business (when there are no outputs). We believe that the clarity provided by

'only' is useful and consistent with the discussion in, for example, paragraph BC26 of the Basis for Conclusions on the exposure draft.
- We believe that the statement in proposed paragraph 805-10-55-5B of the FASB ED that a process is not critical if it is considered ancillary or minor in the context of all the processes required to create outputs would be a useful clarification to add to proposed paragraph B12B.

In terms of the Illustrative Examples proposed for addition to IFRS 3, we note that in general the FASB equivalents include a fuller description of the circumstances surrounding the transaction and that, as a result, they are in some cases more understandable. Specifically:
- The FASB version of Example C (acquisition of a television station) clarifies an ambiguity in the IASB version, which is unclear as to how it is determined that the television station does not have outputs.
- The FASB version of Example D (acquisition of a manufacturing facility) discusses the transaction more clearly and indicates a reason why a workforce that will (or may) not be used has been acquired.

These two examples also relate to the determination of whether an acquiree has outputs "at the acquisition date" (per the IASB ED) or whether there is "a continuation of revenue before and after the transaction" (per the FASB ED). As noted above, we believe the FASB discussion is clearer in this respect.

Question 3

To address diversity of practice regarding acquisitions of interests in businesses that are joint operations, the Board is proposing to add paragraph 42A to IFRS 3 and amend paragraph B33C of IFRS 11 to clarify that:

(a) on obtaining control, an entity should remeasure previously held interests in the assets and liabilities of the joint operation in the manner described in paragraph 42 of IFRS 3; and

(b) on obtaining joint control, an entity should not remeasure previously held interests in the assets and liabilities of the joint operation.

Do you agree with these proposed amendments to IFRS 3 and IFRS 11? If not, what alternative would you propose, if any, and why?

We agree with the specific proposals of the amendments (i.e. that obtaining control of a joint operation that constitutes a business should result in remeasurement, whilst obtaining joint control should not) for the reasons set out in the Basis for Conclusions on the exposure draft. However, to avoid any ambiguity we recommend that:
- it be made clear, either by amending the wording of proposed paragraph 42A or by addition of an illustrative example, how the requirement to 'remeasur[e] previously held interests in the joint operation' applies to a previously held interest accounted for by recognising shares of individual assets and liabilities (which may or may not be held via ownership of equity instruments) rather than (as for an associate, joint venture or financial asset accounted for under IFRS 9 or IAS 39) as a single asset. Specifically, it is unclear whether it refers to remeasurement of the overall interest in the joint operation (i.e. including the value of any goodwill or unrecognised intangible assets) or only of previously recognised individual assets and liabilities; and
- it be stated explicitly in either proposed paragraph 42A or in the Basis for Conclusions on IFRS 3 that the requirements for a business combination achieved in stages apply regardless of whether the joint operation was, or was not, structured through a separate vehicle (i.e. whether there is, in literal terms, a holding of equity instruments).

We also recommend that consequential amendments be made to existing paragraph BC45M of the Basis for Conclusions on IFRS 11, as this paragraph currently includes a discussion of a transaction in which the acquirer obtains joint control that could be read as inconsistent with the proposals in the exposure draft.

More broadly, we are concerned that the proposed amendments do not address either the accounting by the other parties to joint operations subject to such transactions or, particularly as the amendments are proposed as part of an exposure draft on the definition of a business, the accounting for changes in stake in a joint operation that does not constitute a business.

Specifically, it remains unclear what (if any) accounting entries should be made in the financial statements of other participants in a joint operation over which one participant has obtained control (and which is, by definition, no longer a joint operation). Such participants could have lost joint control as a result of the transaction or could have never had joint control and may, or may not, retain the rights to assets and obligations for liabilities of the arrangement that previously resulted in classification as a joint operation. It is unclear whether such a party should continue to recognise a share of the arrangement's assets and liabilities (because its relationship with the arrangement may not have changed) or revert to a different form of accounting (because the arrangement is no longer a joint arrangement within the scope of IFRS 11) and whether any remeasurement should occur.

Question 4
The Board is proposing the amendments to IFRS 3 and IFRS 11 to clarify the guidance on the definition of a business and the accounting for previously held interests be applied prospectively with early application permitted.

Do you agree with these proposed transition requirements? Why or why not?

We agree that the proposed amendments should be applied prospectively for the reasons set out in the Basis for Conclusions on the exposure draft, but recommend that it be specified whether the reference to applying the amendments 'for an earlier period' in proposed paragraph 64N is intended to permit early application in an interim period or whether only application from the beginning of an annual reporting period is permitted.