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Accounting for business combinations: Definition of a business

The accounting standard IFRS 3 *Business combinations* prescribes how transactions in which an entity obtains control over a business should be accounted for. A review of the standard by the IASB indicated that the current definition of what constitutes a business poses certain challenges in practice. The definition of a business has been revised to address some of the concerns raised. A simplified model to assess whether a business is acquired is also introduced into IFRS 3.

IFRS 3 *Business combinations* ('IFRS 3') prescribes how transactions in which an entity obtains control over a business should be accounted for. It applies to various forms of transactions through which businesses are acquired, including a purchase of shares of a company that houses a business, a purchase of the assets and liabilities associated with a business and certain mergers. This article provides a brief overview of a recent amendment to IFRS 3.

Basic principles of IFRS 3

A critical element of IFRS 3 is the determination whether the subject acquired by the reporting entity does in fact constitute a business or not. If it constitutes a business, the acquisition method prescribed by IFRS 3 applies. This requires the acquirer to recognise the identifiable assets and liabilities of the business acquired at their fair values. The difference between these values and the consideration paid represents goodwill or a gain on a bargain purchase. If the subject of the acquisition is not a business, it is accounted for as an asset acquisition, with the purchase price allocated proportionately to the identifiable assets and liabilities.

Current definition of a business

IFRS 3 currently defines a business as:

> an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants

An implementation review of the standard raised concerns with regard to the application of this definition in practice. These include difficulties in evaluating whether processes acquired are sufficient for an acquired set of activities and assets to be considered a business as well as concerns relating to the application of this definition to a set of activities and assets do not generate revenue. The revisions to the definition aim to resolve these difficulties.

Revised definition and guidance

The revised definition of business is:

> 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

The application guidance relating to this definition was expanded significantly to provide further clarity.

Some of the key changes resulting from these revisions are:

- The minimum threshold for an acquired set of activities and assets has been defined. A business at least requires inputs and a substantive process that together significantly contribute to the ability to create outputs. The nature of the relevant outputs have been narrowed to goods or services provided to customers or investment- or other income.
- The standard contains detailed guidance to determine whether a process acquired is a substantive process or not. The guidance distinguishes between scenarios where outputs are generated by the assets and activities at the time of acquisition and where no outputs have been generated yet. The presence of an organised workforce appears to be a critical indicator of a substantive process acquired.

To reduce some of the complexity and judgement involved, an elective simplified assessment model is introduced into IFRS 3. It requires that the concentration of the fair value of the gross assets acquired in a single asset or group of similar assets be considered. If the value is concentrated in a single asset, the set activities and assets acquired is not a business and no further assessment is required. If no such concentration of value in a single asset exists, the application of the above definition and guidance must be applied to determine whether a business was acquired or not.

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