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Mr Hans Hoogervorst
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Our ref MV/288

31st October 2016

Dear Mr Hoogervorst

Comment letter on ED/2016/1 *Definition of a business and accounting for previously held interests*

We appreciate the opportunity to comment on the International Accounting Standards Board's (IASB) Exposure Draft ED/2016/1 *Definition of a business and accounting for previously held interests* (the "ED"). We have consulted with, and this letter represents the views of, the KPMG network.

We support the IASB's decision to clarify and narrow down the current, overly broad definition of a business. As highlighted in the post-implementation review of IFRS 3 the current definition has led to diversity in practice and has been considered difficult to implement by preparers and auditors. We believe that subject to further refinements the proposals will address these concerns.

Accordingly, we encourage the IASB to pursue its test-based approach and support the mandatory application of the asset concentration test. We believe that the operation of the asset concentration test could be refined, however, and we make recommendations in our answers to the Board's questions, included in the appendix to this letter.

We also have concerns that the workforce and process tests as drafted may not achieve the objective of narrowing the definition, and we make recommendations in the appendix. Connected with these concerns, we believe that the examples provided need to be enhanced to make them more realistic and to depict and explain difficult judgements. Finally, the structure and drafting of the proposals could represent a significant obstacle to the goal of clarifying the definition. These need to be addressed to avoid implementation issues and different interpretations.

The appendix to this letter contains our detailed responses to the questions in the exposure draft and highlight the areas where we seek enhancements.



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*Comment letter on ED/2016/1 Definition of a business and accounting for previously held
interests
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Please contact Mark Vaessen or Mike Metcalf +44 (0)20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG IFRG Limited

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Appendix: Responses to questions posted by the IASB

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?

Asset concentration test

We agree with the application of an asset concentration test and welcome this test as it narrows down the definition of a business. However, there are some areas where we believe that refinements are needed.

When performing the asset concentration test, there are two ways to determine the fair value of the gross assets acquired, either:

- compute the total of the fair values of all acquired inputs, contracts, processes, workforce and any other unidentifiable intangible asset plus goodwill (direct method); or
- gross-up the fair value of the consideration paid by the fair value of the liabilities assumed (indirect method).

The ED is written as if the direct method is the default and the indirect is only a fall-back option. However, we believe that the direct method is difficult, if not conceptually impossible.

The direct method will result in an entity having to perform valuations which will be difficult in practice (e.g. valuation of processes and assembled workforce) as well as some valuations that we believe to be conceptually impossible, such as the valuation of goodwill, which is per definition a residual and arises only on a business, whereas the test sets out to determine if there is a business or not. (If goodwill is not included in the direct method then it will yield a different answer from the indirect method¹.) We expect

¹ E.g., 100 is paid as consideration. There are no assumed liabilities. The only asset, identifiable or otherwise, is worth X. The indirect method gives a result of X% (X/100), but the direct method, without adding in goodwill, gives 100% (X/X). Yet to add in goodwill as required

it to be difficult to overcome the valuation challenges of a direct determination. In addition, we expect that the indirect method will be simpler to apply to acquisitions of services. We recommend removing the direct method.

The indirect method itself would benefit from some clarifications:

- Cash acquired does not itself have any relation to whether there is a business or an asset acquisition. For example, if a single asset is acquired in a corporate wrapper that includes in addition a significant amount of cash, this would not constitute a business acquisition. Therefore, we suggest exclusion of the amount of cash acquired from the consideration paid for purposes of the asset concentration test (similar to IAS 7 paragraph 42).
- It may be difficult to fair value some of the liabilities assumed, in particular deferred tax liabilities. The two possible solutions are to disregard deferred tax or to bring it in at IAS 12 amounts ignoring the initial recognition exemption. The first has practical simplicity and the second will usually over-state the denominator in the test (broadly speaking, adding undiscounted deferred tax to a price reflecting discounted deferred tax). We recommend the first solution.
- When a group of assets is purchased the consideration may include future variable payments. Since the accounting for these has been a source of difficulty (e.g. at IFRS IC), then it would be advantageous to be clear about how they are to be included in this test: total future payments expected to be made or the fair value as at purchase date of the obligation that may lead to future payments (the price that would be paid to settle it on day one).
- When the acquisition results from an off-market intra-group transaction, objective adjustments to the actual consideration paid may be necessary. Otherwise, the indirect method could lead to wrong conclusions in some cases (e.g. assets are not concentrated but the consideration paid is significantly below market price). A similar approach could be used for (third party) bargain purchases.

The guidance for combining assets into a single identifiable asset or grouping similar identifiable assets together is key for applying the asset concentration test. We suggest revisiting paragraphs B11B / B11C after considering more examples, such as interrelated assets like airports, hotels or shopping malls.

The acquisition of an operating airport, for example, intuitively seems to be a business acquisition. An airport comprises an operating permit as well as various tangible assets (runway, tower, terminal, car park etc.) and customer contracts (licensing out landing

for the direct method one has to assume the result of the asset concentration test (i.e. business acquisition), and then derive goodwill from the price paid of 100. Goodwill cannot be independently valued.

slots to airlines). However, it is not entirely clear whether an airport is a business when paragraph B11B is applied as the proposed guidance points in different directions:

- The operating permit would be recognised together with the tangible assets (see IFRS 3.B32(b)). In addition, the customer contracts are similar to leases and may, therefore, be recognised together with the tangible assets too (see IFRS 3.B42). This will tend to concentrate the assets.
- The first sentence in paragraph B11B will tend to reduce the asset concentration as there are various tangible assets that are separately identified and measured in a business combination (e.g. land, terminal and runway will inevitably be separate going forward).
- The second sentence in paragraph B11B tends to concentrate the assets as all significant tangible assets are attached to the land while the separate use (disregarding the airport operations) would significantly diminish each asset's fair value.

We think that it would be a valuable exercise for the IASB to consider how it intends its approach to apply to such a case and then make any necessary revisions and simplifications to the principles in the light of that.

We note that the FASB decided that similar assets are assets that are exposed to similar risks. This could be an alternative approach for grouping assets. However, this approach does not seem to be self-explanatory either. For example, are investment properties in different locations or mortgage portfolios for different countries or ratings exposed to the same risks? Some may believe they are, while others may believe that they are not.

Whilst we do not have a ready-made solution to offer, we recommend further consideration of the matter by the Board, as without improved guidance diverse interpretations may arise. Therefore, we recommend to provide clear and unequivocal guidance regardless of the approach selected for grouping similar assets.

Process tests

Based on the proposed drafting, the process tests appear to be relatively low hurdles. It requires either:

- an organised workforce that is able to perform an acquired process that is critical; or
- if the set of activities and assets has outputs, a process that is considered unique or scarce, or cannot be replaced without significant cost, effort, or delay. (paragraphs B12A, B12B).

“Critical”, “unique” or “scarce” at first sound like high hurdles (although it is not self-evident as to how any one of those hurdles differs from the others – different ways for saying the same thing?). However, upon further reading, the tests represent rather lower hurdles.

In accordance with paragraph B12A every process that is more than just ancillary or minor within the context of all the processes required to create output is considered to be “critical”. Paragraph BC26 seems clear that a critical process is merely one that is necessary even if also widely available, and that the test is passed (i.e., there is a business) if the workforce merely has the necessary skills to perform that widely available process. This test would be too easily met, even though we do not believe that such is the intention of the Board.

Furthermore, we believe that replacing a process will in many cases involve significant cost, effort, or delay. Therefore, in many cases it will not be necessary to have a unique or scarce process as the delay criterion will be fulfilled no matter whether a process is unique / scarce or not.

We encourage the IASB to amend the tests:

- to turn the “critical” test into a simpler, more direct one of whether replacing the acquired workforce would cause significant cost, effort and delay in the production of output or the development of outputs. This would replace the current two stage test (testing the nature of the process and then testing the necessity of the workforce to that process) with a one-stage test (inferring the importance of the process from the difficulty in replacing the workforce). There would need to be an exception for difficulty etc. in replacing a workforce due to employment law, which has no connection to the concept of a business;
- to require that a process cannot be replaced without significant cost, effort, and delay. If the “or” is replaced by an “and”, then scarce and unique can and should be removed as separate criteria for two reasons. First, scarce and unique would be addressed by the amended wording, which introduces a higher hurdle. Second, scarce and unique are not defined and, therefore, could leave room for future debate (e.g., as they have been presented during the IASB’s webcast as synonyms of “cannot be replaced without significant cost, effort, or delay”).

This approach would also involve the simplification of a single formula – “cannot be replaced without significant cost, effort, and delay” – for both tests – workforce (that performs a process) and a process not involving a workforce.

Inputs

The need for an acquired input is woven into the process and workforce tests. As well as making the tests more difficult to comprehend, this results in the key point about inputs being lost/ under-developed.

The issue is that any asset is an input, and so every case where one has to decide between an asset acquisition and a business acquisition must involve an input. Therefore at that level the test seems redundant in practical terms. However, it may be that the Board intends that where there are no current outputs, then the acquired input must be capable of being developed or converted into an output. That would mean that inputs such as a factory does not qualify (as per Example D). The point may need some development, however. For example, an office building is no more capable of being developed or converted into an output than a factory, and yet the purchase of a number of such investment properties could be a business (Example I). On the other hand, it may be that the test is intended only for cases when there are no current outputs, which seems more reasonable; however, we believe that the IASB needs to give this some further consideration before confirming that. For example, is it from a conceptual point of view sufficient also to acquire inventory in order to consider an idle factory to be a business? And if it is, how much inventory is required to pass the input test?

Structure

IFRS 3 *Business Combinations* currently contains a definition of a business in Appendix A and, in different language, application guidance in (what is now) paragraphs B7-B8, B9-B11. This is already less than ideal. The proposed amendments including the new test-based approach introduce a third set of provisions and hence further ambiguity. If this new, third set is the definitive one, as we believe is intended, then we should expect the other two to be removed (or at least be significantly modified). However, as they have not been removed (or significantly modified) they will lead to some interpreting the new provisions as the operative provisions and others having resort to the older provisions in some or all cases, leading to diversity.

In particular, the new test-based approach may be interpreted as a practical expedient and users may refer to the general definition of a business in order to override, for example, the asset concentration test. However, we do not believe that this is the intention and agree that the new tests should be mandatory and a complete set of tests without needing reference to other guidance, definitions or tests. Therefore, to overcome these problems, we believe that the existing definition and guidance should be removed.

Additional comments on the proposals

Additionally to the specific comments on the test-based approach, we have the following comments on the proposals:

- **Guidance on outsourcing:**

We support the IASB's proposal to include guidance on outsourced workforce and to treat it similarly to any other workforce acquired. As such we recommend stating in paragraph B12C that an outsourced workforce is a workforce and so the workforce test applies in the normal way. If that workforce test were recast along the lines that

we suggest above (replacement would cause significant cost, effort and delay) then this test would also be suitable to such a workforce (and outsourcing contract terms and renewal clauses may provide indications for that assessment).

■ Illustrative examples

We recommend enhancement of the illustrative examples provided. It would be useful for preparers if the examples involve difficult judgement and illustrate how that judgement may be applied in practice.

It also appears that some of the examples provided do not reflect real life. For example, they assume that there is significant fair value in the workforce in Examples E, I and K. In practice, we would expect the fair value of the workforce acquired to be insignificant compared to, for example, investment properties or mortgage loan portfolios. Similarly, we believe that the value of equipment and gathering system is not always significant when compared to a mineral interest, e.g. contrast on- and off-shore (Example J). In addition, we would expect e.g. a manufacturing facility with only free-standing equipment (Example D) to be rare in practice.

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?

While as a global network we remain committed to a single set of high quality global accounting standards and consider that convergence is an important factor promoting the efficiency of financial markets, we would encourage the IASB to focus on the applicability and understandability of the proposals, which we believe are more important than formal text convergence.

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?

There is currently significant diversity in practice and uncertainty in the accounting for previously held interests. We appreciate the IASB clarifying the issue and agree with the proposed amendments.

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 early application should be permitted so that companies can benefit from the clarifications to the definition of a business and the accounting for previously held interests as soon as possible.

While we believe that in general retrospective application of an amendment is the appropriate accounting, we also acknowledge that the IASB has in the past, almost invariably, required prospective application of various amendments to IFRS 3 and IFRS 11. Therefore, we have no objections continuing this approach.