COMMENTARY ON CHANGES TO IFRS 3 BUSINESS COMBINATIONS

by Tessa Park, Technical Partner of Moore Kingston Smith

Introduction

The IASB has introduced some changes to IFRS 3 'Business Combinations' which apply for accounting periods beginning on or after 1 January 2020. The key change is to the definition of a business.

The changes, which are applied prospectively to transactions taking place on or after the effective date of the amendments, will change the accounting for some transactions which, had they occurred prior to the effective date of the amendments, would have been accounted for as business combinations but now will not be. Some such transactions will be accounted for as asset acquisitions but others may need to be accounted for in a different way depending on the circumstances.

Definition of a business

The new definition of a 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 generating other income from business activities'.

This changes the emphasis of the definition to providing something to customers or otherwise generating income, and therefore makes it more difficult to justify that an entity is a business if it is not actually generating any income. This does not automatically mean that an entity which is not selling something is not a business. However, if an entity is not generating income, it does need to have both:

- a substantive process that is capable of generating outputs (i.e. income); and
- an organised workforce that has the skills, knowledge and experience to perform the process.

As well as this change in focus, the revisions to the Standard requires a careful consideration of whether what has been acquired constitutes a business or not, which includes consideration of how the value of what has been acquired is actually made up.

The steps of the process are:

a) Consider whether to apply the optional 'concentration test' (see below);
b) Consider what assets have actually been acquired - is it a single asset or a group of assets together with related processes;
c) Consider how the fair value of those assets is concentrated – and specifically whether the value is concentrated in a single identifiable asset or group of similar assets;
d) Consider whether what has been acquired has outputs; and
e) If there are no outputs, and a process has been acquired, consider if it is a substantive process which is capable of generating outputs.

Where 'assets' are referred to this means gross assets rather than net – liabilities are disregarded when making the assessment.

The optional 'concentration test' short-cuts the process of determining if what has been acquired is not a business – if the test is applied, and substantially all the fair value of the gross assets acquired is concentrated in either a single identifiable asset or a group of similar identifiable assets, then what has been acquired is not a business. For the purpose of applying the test, acquired cash and cash equivalents, deferred tax assets, and any goodwill resulting from the effects of deferred tax liabilities are not included in the consideration of the fair value of the gross assets acquired.

How will the accounting be affected?

If what has been acquired is not a business, then the accounting for the acquisition will be very different from accounting for a business combination under IFRS 3. If an asset (or group of assets) has been acquired then although these assets will be recognised in the acquirer's consolidated financial statements, they will not be subject to fair value adjustment but will be recognised at cost (i.e. the fair value of the consideration).

No goodwill will be recognised and any costs associated with the acquisition (e.g. directly attributable legal costs) will be capitalised as part of the cost of the assets acquired, rather than expensed to

consolidated profit or loss. There will also be implications for the recognition of deferred tax. There may be other implications for the accounting which will need to be considered on a case by case basis.

Examples

Example 1: early stage biotech company

Startup Ltd is an early stage biotech company which is undertaking research and development into antiviral drugs. An offer to acquire the company is received from a large pharmaceutical company which the company's directors decide to accept. As at the date of acquisition, Startup Ltd is in the process of developing a drug to treat a particular strain of virus although the directors estimate they are at least a year away from being able to market the product. They have an organised workforce of scientists conducting the research and development process as well as management and administration staff.

Although Startup Ltd is not generating any revenue, it is undertaking a research and development process which is being developed in the expectation of generating outputs and indeed is critical to being able to generate those outputs. The acquisition of Startup Ltd would therefore be accounted for as a business combination in accordance with IFRS 3 by the pharmaceutical company, despite the lack of generation of revenue to date.

Example 2: technology company where activities have been suspended

Appy Ltd is a company which has been developing an app for use on mobile phones and other devices. Although it has undertaken activities in the past (i.e. work on developing the app) it had not reached the stage of making sales, and the development activities were suspended approximately one year ago due to the company not being able to obtain sufficient funding to continue with the development. The majority of the staff, including the developers, have been laid off.

A larger listed technology company sees potential in the app and makes an offer to acquire Appy Ltd.

At the date of the transaction, Appy Ltd does not have a substantive process or an organised workforce and the value of the organisation is concentrated in the IP for the app. It is therefore not a business and the transaction is not a business combination. IFRS 3 therefore does not apply and the acquirer will account for the transaction as an asset acquisition.

Tessa Park

Technical Partner

Moore Kingston Smith

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