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Business Combination Series

Definition Of Buisness Combination

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Preface

Welcome to our 'Business Combination' series, a comprehensive exploration of the International Financial Reporting Standard that governs accounting for business combinations, IFRS 3. In this series, our objective is to provide clear guidance on IFRS 3, titled 'Business Combinations,' offering financial professionals, stakeholders, and decision-makers practical insights into the accounting rules that shape the treatment of mergers and acquisitions in the financial world.

Business combinations are transformative events with distinctive features. IFRS 3 serves as the guiding framework for recognizing and measuring assets and liabilities in these transactions. This standard has been in place for over a decade and has undergone thorough evaluations by the International Accounting Standards Board (IASB).

Each episode in this series is carefully curated to unpack the complexities of the business combination, presenting concepts in a clear and actionable manner. From the basics to advanced techniques, we will explore various aspects of deal structures, delving into real-world case studies, tax issues, contract issues, regulatory issues, and practical applications. Our goal is to equip you with the tools and knowledge necessary to make informed financial decisions, whether you are involved in mergers and acquisitions, real estate transactions, or any other financial deal.

The research underlying this report was run by the dedicated team of Helios Financial Group M&A practice, led by Asad Khan, a partner.
Valuable perspectives and advice were offered by a distinguished panel of academic and industry experts. Including, various articles, publications, books and research materials.

The report also benefited enormously from the contributions of HFG's global network of industry experts. It drew on HFG's indepth analytical expertise, our work with leading preferred acquirer organizations, distinguished lawyers, esteemed tax advisors and our understanding of deals space around the world.

The authors would like to thank the external and internal advisers for their contributions. In addition, the authors would like to thank Ammad Ahmed and Waqas Ahmed for their help in art directing, producing, and disseminating this report.

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1. This report was not commissioned or sponsored in anyway by a business, government or other institution.
2. Debra C. Jeter, Paul K. Chaney (2018), Advanced Accounting
3. Grand Thornton, Insights into IFRS 3
4. PWC Insights, Business Combinations
5. By reviewing this paper, no individual is endorsing its conclusions. All errors remain our own

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This edition of "Insights," a part of our Business Combination Series, delves deep into the heart of defining a business combination. What does it mean for an acquirer to obtain control over one or more businesses? How do you determine whether what has been acquired indeed constitutes a 'business,' and whether 'control' has been effectively secured by the acquirer?

Through our publications in Business Combinations Series, we aim to provide clarity and practical guidance to navigate the complexities of IFRS 3.

DEFINITION OF BUSINESS COMBINATION

A 'business combination' is defined as a 'transaction or other event in which an acquirer obtains control of one or more businesses'. Identifying a business combination transaction therefore requires the determination of whether what is acquired constitutes a 'business' and whether 'control' has been obtained by an acquirer.

Definition of Business

IFRS 3 defines a business as an "integrated set of activities and assets that is capable of being conducted and managed to provide goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities." To provide further clarity in determining the existence of a business, IFRS 3 offers guidance centered on three fundamental elements: inputs, processes, and outputs.

While the conventional perception is that businesses are associated with outputs, it's important to note that outputs are not an absolute prerequisite for an integrated set of activities and assets to qualify as a business under IFRS 3. Instead, to be classified as a business, the acquired set of activities and assets must encompass, at the very least, an input and a substantive process that collectively make a significant contribution to the capacity to generate outputs.

Crucially, the litmus test for whether a specific grouping of assets and activities constitutes a business hinge on whether a potential market participant could feasibly conduct and manage this integrated set as a business. In this assessment, it is immaterial whether the seller, who may have been the previous owner of these assets and activities, actually operated them as a business or whether the acquirer, the prospective new owner, intends to manage them as a business.

In essence, IFRS 3 emphasizes the capability of the integrated set to function as a business, irrespective of the historical or future intentions of the parties involved. The criteria for identifying a business involve scrutinizing the potential functionality and not the past or future actions of the entities, ensuring a rigorous and market-oriented assessment.

THE THREE ELEMENTS OF A BUSINESS

In order to meet the definition of a business, the acquired set of activities and assets must have inputs and substantive processes that can collectively significantly contribute to the creation of outputs.

Elements	Explanations	Examples
INPUT	An economic resource that creates outputs or can contribute to the creation of outputs when processes are applied to it.	• Tangible fixed assets • Right-of-use assets • Intangible assets • Intellectual property
PROCESSES	A system, standard, protocol, convention, or rule that when applied to an input, creates outputs or can contribute to the creation of outputs.	• Strategic management processes • Operational processes • Resource management processes
OUTPUTS	The result of inputs and processes applied to those inputs that provide goods or services to customers, generate investment income (such as dividends or interest) or generate other income from ordinary activities.	• Revenue

Is the acquired process substantive?

The Standard introduces a fundamental requirement for entities to evaluate the substantive nature of the acquired process. To facilitate this assessment, the Standard has incorporated comprehensive guidance and illustrative examples. The analysis, however, diverges based on whether the acquired set of activities and assets includes outputs or not.

DEFINITION OF BUSINESS COMBINATION

In cases where the acquired activities and assets lack outputs, such as a newly established entity yet to generate revenue, the evaluation focuses on the presence of outputs at the acquisition date. If the acquired activities and assets are generating revenue at the acquisition date, they are considered to possess outputs.
For activities and assets without outputs at the acquisition date, the acquired process is deemed substantive only under specific conditions:

1. It must be indispensable for developing or transforming acquired inputs into outputs

2. The inputs acquired should encompass both an organized workforce with the requisite skills, knowledge, or experience to execute the process and other inputs that the organized workforce can develop or transform into outputs. These additional inputs may encompass elements such as technology, ongoing research and development projects, real estate, and mineral interests.

In cases where activities and assets have outputs at the acquisition date, the assessment of substantive status is determined by different criteria:

1. It must be critical for the continuous production of outputs, and the acquired inputs should include an organized workforce with the necessary skills, knowledge, or experience to execute the process.

OR

2. It should make a significant contribution to the ongoing production of outputs and be characterized as unique, scarce, or irreplaceable without incurring substantial costs, effort, or delays in output production.

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In essence, the Standard lays out distinct criteria for assessing the substantive nature of acquired processes, taking into consideration whether outputs are present and various factors that influence the evaluation of these processes in the context of a business combination

Definition of Control

IFRS 3, in its essence, adopts the perspective of the acquirer in the context of business combinations. The nature of business combinations necessitates the clear identification of one party as the acquirer and the other as the acquiree. While in straightforward business combinations, this identification process is straightforward, with the legal acquirer typically being the acquirer, the landscape can become more intricate in cases where business combinations are structured in diverse manners.

The foundation for defining control, a pivotal concept in IFRS 3, is derived from IFRS 10, which furnishes comprehensive guidance for determining the existence of control in various scenarios. In essence, control is established when an investor is exposed to variable returns from its involvement with an investee and possesses the ability to influence those returns through its authority over the investee. Control can be realized through multiple mechanisms, including but not limited to the transfer of cash or the issuance of equity shares. These structures may vary based on legal, tax, or other strategic considerations.

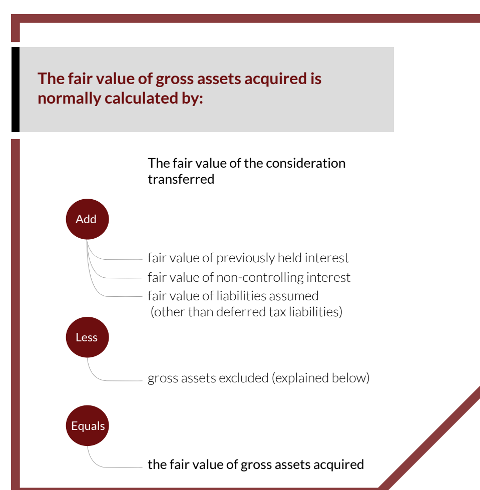
For a more detailed exploration of the process of identifying the acquirer in business combinations, will be discussed in later parts of our Business Combination Series.

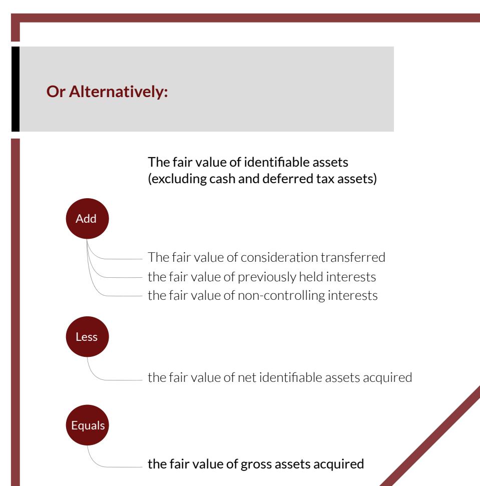
CONCENTRATION TEST.

The amendments bring forth an optional evaluation method referred to as 'the concentration test,' which offers the acquirer a simplified means of ascertaining whether the acquired set of activities and assets should not be classified as a business. This concentration test grants flexibility to the entity, allowing them to decide on a transaction-by-transaction basis whether or not to employ this test. If the concentration test yields a positive outcome, signifying that a significant portion of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets, then the acquired activities and assets do not qualify as a business, and no further assessment is necessary. However, if the concentration test criteria are not met, or if the entity chooses not to apply the test, then the entity must proceed with the standard assessment to determine whether the acquired set of assets and activities aligns with the conventional definition of a business.

It is crucial to clarify that this concentration test focuses on the fair value of gross assets, which is explicitly defined (with certain assets being excluded), and the Standard offers guidance on how to calculate fair value. Importantly, liabilities are not taken into account in this assessment, as the presence of liabilities is a common feature in most businesses and does not disqualify an entity from being classified as a business. Likewise, an acquired set of activities and assets that does not meet the criteria for being classified as a business may still include liabilities. The amendments also provide additional guidance on what constitutes a single identifiable asset or a group of similar identifiable assets for the purposes of this concentration test.

Fair value of gross assets can be calculated in any of the following ways:





PRACTICAL INSIGHTS

IFRS 3's application guidance provides further guidance on the concentration test, specifying that 'gross assets' acquired do not include cash and cash equivalents, deferred tax assets and goodwill arising from the effects of deferred tax liabilities. It also explains that certain types of assets should not be considered similar, for example different classes of intangible fixed assets should not be considered similar assets.

IFRS 3 does not, however, define 'substantially all' or provide any guidance on how this term should be interpreted. Applying the 'substantially all' criterion therefore requires judgement. In practice an accounting policy may be developed to ensure the consistent application of this criterion, which is sometimes interpreted as meaning greater than 90% for this purpose.

RECOGNIZING IDENTIFIABLE INTANGIBLE ASSETS: WHAT IFRS 3 PERMITS

Is a single identifiable asset or a group of similar identifiable assets acquired?

As the Standard clarifies that the concentration test is considered successful when the fair value of the gross assets acquired is predominantly centered in a single identifiable asset or in a cluster of similar identifiable assets. Let's delve into the distinct elements of this test in more detail:

Type of identifiable asset	Explanations	Examples
SINGLE IDENTIFIABLE ASSET	Includes any asset or group of assets that would be recognised and measured as a single identifiable asset in a business combination. Includes assets that are attached or cannot be removed from other assets without incurring significant cost or loss of value of either asset	• Land and buildings • Customer lists • Trademarks • Outsourcing contracts • Product rights • Equipment
GROUP OF SIMILAR IDENTIFIABLE ASSETS	Assets are grouped when they have a similar nature and have similar risks associated with managing and creating outputs from the assets. By breaking down the concentration test into these elements, the Standard provides a structured framework for assessing whether the fair value of the acquired assets is notably concentrated, thereby aiding in the determination of whether the set of activities and assets qualifies as a business.	Examples of combinations not considered to be similar assets: • Tangible assets and intangible assets • Tangible assets that are recognised under different Standards (eg IAS 2 'Inventories' and IAS 16 'Property, Plant and Equipment') • Dfferent classes of assets under IAS 16 (unless considered a single identifiable asset) • Fnancial assets and non-financial assets • Different classes of financial assets under IFRS 9 'Financial Instruments' • Assets within the same class but which have significantly different risk characteristics

CONCLUSION

In conclusion, our exploration of the definition of a business combination within the framework of IFRS 3 has illuminated the intricate interplay of elements crucial to identifying such transactions. The emphasis on the three fundamental components—inputs, processes, and outputs—has provided a comprehensive lens through which to evaluate whether an acquired set of activities and assets constitutes a business. The nuanced criteria for assessing the substantive nature of acquired processes, contingent on the presence or absence of outputs, further underscore the meticulous nature of this determination.

The concept of control, central to IFRS 3, places the acquirer at the forefront, with a clear delineation between the acquiring and acquired entities. The multifaceted nature of control, as derived from IFRS 10, recognizes that influence can manifest through various mechanisms, reflecting the diverse structures prevalent in business combinations.

The introduction of the concentration test as an optional evaluation method adds a layer of flexibility for entities, allowing them to streamline the assessment process. This test, while offering a simplified route, necessitates careful consideration of the fair value of gross assets and the definition of a single identifiable asset or a group of similar identifiable assets. The practical insights provided by IFRS 3's application guidance offer valuable clarity on exclusions and interpretations, guiding practitioners through the intricacies of this concentration test.

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Endnotes

1. Debra C. Jeter, Paul K. Chaney (2018), Advanced Accounting
2. Grand Thornton, Insights into IFRS 3
3. PWC Insights, Business Combinations
4. Based on HFG's own consultative experience of working with clients on Mergers & Acquisitions.
5. By reviewing this paper, no individual is endorsing its conclusions. All errors remain our own.

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