IFRS news

June 2019

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Release Date: 30 April 2019

The new definition of a business promises to impact the real estate industry – PwC In brief

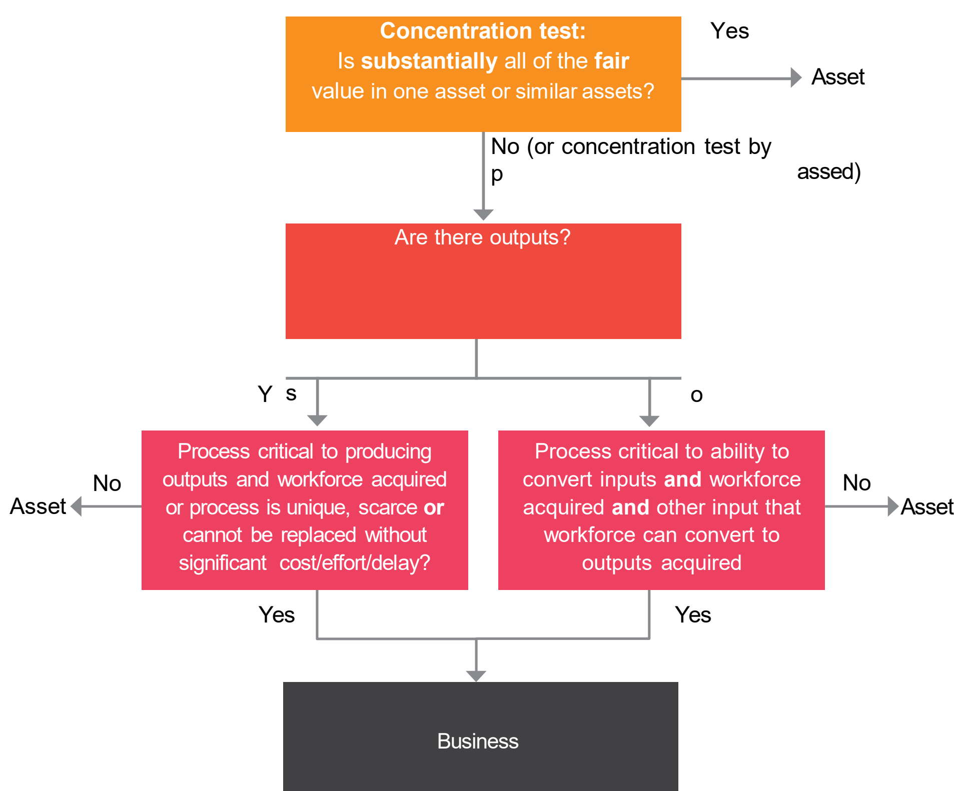
At a glance

The IASB's new guidance changes the definition of a business and will likely result in more transactions being recorded as asset acquisitions. The new definition of a business could have a significant impact in the real estate (RE) industry.

What is the issue?

New guidance

IFRS 3, 'Business Combinations', has been amended to update the definition of a business. The new model introduces an optional concentration test that, if met, eliminates the need for further assessment. To be considered a business, an acquisition would have to include an input and a substantive process that together significantly contribute to the ability to create outputs. The new guidance provides a framework to evaluate when an input and a substantive process are present.



The concentration test

Under the concentration test, companies consider whether substantially all of the fair value of the gross assets acquired is concentrated in a single asset (or a group of similar assets). If so, the assets acquired would not represent a business and no further analysis is required. Gross assets acquired exclude cash, deferred tax assets and any goodwill that results from the effects of deferred tax liabilities. The fair value of the gross assets acquired can usually be determined based on the consideration transferred (plus the fair value of any non-controlling interest and previously held interest, if any) plus the fair value of any liabilities assumed, other than deferred tax liabilities. In order to compare like with like, any items excluded from the 'gross assets acquired' would also be excluded from the fair value of gross assets acquired calculation.

The optional concentration test includes the concept of aggregating 'similar' assets. In the RE industry, it is common for acquisitions to include several properties. Companies should carefully consider the specific facts and circumstances, including class of property and location when concluding whether assets purchased in a transaction are similar. A group of properties are not similar if they have significantly different risk characteristics. [IFRS 3 para B7B(f)(vi)].

Acquisition of a residential real estate portfolio

Property Co purchases a portfolio of 10 residential homes. Each home is considered to be a separate investment property for accounting purposes. All homes are leased out to separate tenants and comprise land and buildings. Each home has a different design and layout but all homes are located in the same geographical area and the risk profile of the real estate market across that area is similar. No employees, other assets or other activities are transferred.

Is the arrangement the acquisition of a business?

Analysis

No. Property Co elects to apply the optional concentration test and would conclude that this is an asset acquisition, because substantially all of the fair value is concentrated in a group of similar assets. Property Co would treat this as an asset acquisition, assuming that it opted to use the concentration test.

A transaction is not automatically a business combination if the optional concentration test does not result in an asset classification. An entity would then need to assess the transaction under the full framework in IFRS 3.

Framework in IFRS 3

IFRS 3 requires a business to include, as a minimum, an input and a substantive process that together significantly contribute to the ability to create output. The new guidance provides a framework to evaluate when an input and a substantive process are present, differentiating between transactions with outputs and those with no outputs. Outputs are defined as 'the results 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'. [IFRS 3 para B7].`

Without outputs

An acquired process is considered substantive where:

1. the process is critical in converting an acquired input to an output;
2. the inputs acquired include an organised workforce that has the necessary skills, knowledge and experience to perform that process; and
3. other inputs are acquired that can be developed or converted into outputs by the organised workforce, for example, intellectual property, other economic resources that could be developed to create outputs, or rights to obtain materials or that enable future output to be created.

With outputs

An acquired process is considered substantive where, either:

1. the process is critical in continuing to produce outputs, and the input includes an organised workforce with the necessary skills, knowledge or experience to perform that process; **or**
2. the process significantly contributes to the ability to continue to produce outputs and is unique or scarce or cannot be replaced without significant cost.

Contracted workforce

An acquired contract could give access to an organised workforce (for example, outsourced property management services). The entity needs to assess whether the organised workforce provides a substantive process that it controls. Factors to consider include: the service is not ancillary or minor; it would be difficult to replace the workforce; and the duration of the contract and renewal terms.

Acquisition of a residential and office real estate portfolio

Property Co purchases a portfolio of 10 residential homes (the nature of these homes being as outlined in the example above) as well as an office park containing 5 fully let office buildings. In addition, an outsourcing contract for maintenance services for the office park is also acquired. The maintenance services are considered ancillary or minor in the context of generating rental income at the office park. No employees, other assets or other activities are transferred.

Is the arrangement the acquisition of a business?

Analysis

No, Property Co would conclude that this is an asset acquisition.

The concentration test is not passed, since all of the fair value is not concentrated in a single identifiable asset or a group of similar identifiable assets; this is because two dissimilar classes of real estate with different risk profiles are acquired.

Since there are leases in place for both the residential homes and office park buildings, Property Co would then analyse the transaction, referring to the framework with outputs and considering whether the acquired processes are substantive. No organised workforce is acquired and the maintenance services are considered ancillary or minor in the context of generating rental income. Further, the maintenance services do not significantly contribute to the ability to generate rental income and also could be replaced without significant cost.

Would the answer be different if there were no in-place lease contracts and, therefore, no outputs?

Analysis

No, Property Co would still conclude this is an asset acquisition.

In order for the definition of a business to be met when there are no outputs, an organised workforce with the necessary skills critical to the ability to develop and convert the inputs into outputs would need to be present. As no such organised workforce is acquired, the definition of a business is not met.

Acquisition of a residential and office real estate portfolio

Property Co acquires a portfolio of residential and office assets (the nature of these assets being as outlined in the example above) and also acquires employees that are responsible for operational management of the assets as well as all tenant management and leasing activity.

Is the arrangement the acquisition of a business?

Analysis

Yes. Property Co would conclude that this is a business combination.

The concentration test is not applied, because the fair value of the assets acquired is not concentrated in a single asset or a group of similar identifiable assets.Further analysis is required, following the framework with outputs, to assess whether a process is acquired and whether the process is substantive. A business is acquired, because the organised workforce is a substantive process with the necessary skills that is critical to the ability to develop and convert the inputs (land, buildings and in-place leases) into outputs.

What is the impact of more asset acquisitions?

The changes to the definition of a business will likely result in more acquisitions being accounted for as asset acquisitions. There are a number of accounting differences between business combinations and asset acquisitions; these include the recognition of goodwill and the divergent treatment of deferred taxes, contingent consideration and transaction costs, amongst others.

Application of the changes will also affect the accounting for disposal transactions, since the requirements of IFRS 10 apply to the recognition of proceeds from the sale of a business, whereas the requirements of IFRS 15 apply to the recognition of proceeds from the sale of an asset. IFRS 10 requires the consideration received to be recognised at fair value; IFRS 15 constrains variable consideration where it is highly probable to reverse.

When does it apply?

Entities are required to apply the amend- ments to business combinations for which the acquisition date is on or after the begin- ning of the first annual reporting period beginning on or after 1 January 2020. Earlier application is permitted (subject to EU en- dorsement for EU application).

Release date: 16 May 2019

The latest on IFRS 17 implementation

IASB agrees to a 90 day comment period on the forthcoming exposure draft on amendments to IFRS 17 and proposes additional clarifications to IFRS 17

In addition to agreeing to a shortened comment period for the exposure draft, the IASB revised the scope of its previously proposed amendment for contracts with investment return services and discussed a few other sweep issues related to IFRS 17

At a glance

At the 15 May 2019 IASB meeting, the Board considered some additional amendments to IFRS 17. These related to 'sweep issues', which are issues that have arisen after the Board's main deliberations and that need to be clarified by the Board in a public meeting.

The IASB agreed

- to extend the scope of its tentative decision from the January 2019 meeting related to amortisation of the contractual service margin for contracts that include an investment return service. The Board agreed to propose that such services could, in certain situations, also be present in the absence of an investment component;
- to propose two minor clarifications relating to revenue disclosures and presentation;
- to retain the current description in the Basis for Conclusions related to mutual entities; and;
- to a 90 day comment period for the forthcoming exposure draft of amendments to IFRS 17. The exposure draft is expected to be published at the end of June 2019.

The views in this In transition are based on our observations from the 15 May 2019 meeting, and they might differ in some respects from the official report of the meeting that will be published by the IASB in the IASB Update at a later date.

Background

1. Since the issuance of the standard, IASB established a transition resource working group (TRG) to provide a public forum for stakeholders to follow the discussion of questions raised on implementation of the new standard. In addition both the IASB staff and IASB Board members have been engaged in a variety of activities with stakeholders to follow the implementation of IFRS 17. At the IASB meeting on 24 October 2018, the Board agreed to explore potential amendments to IFRS 17 based on a list of implementation issues and concerns compiled by the staff. The Board noted that the criteria set a high hurdle for change, and any amendments suggested would need to be narrow in scope and deliberated quickly to avoid significant delays in the effective date.

2. From October 2018 to April 2019 the IASB evaluated the reported concerns and implementation challenges against the criteria for potential amendments, both on an individual basis and, in April 2019, as a whole. The staff noted that as part of this, both staff and the Board have reviewed possible approaches to dealing with the concerns and implementation challenges. In total, the process has resulted in 12 proposed narrow scope amendments in 8 different areas of IFRS 17 in addition to several clarifying amendments that are classified as annual improvements. These latter amendments are minor changes that clarify the words in a standard or correct relatively minor unintended consequences, oversights, or conflicts between existing requirements in a standard.

Items discussed during the May IASB Board meeting

3. The following topics related to insurance contracts where considered by the IASB in the meeting:.

Staff paper	Description	IASB Decision
02A – Summary of the April TRG meeting	IASB summary of the Transition Resource Group for IFRS 17 Insurance Contracts meeting held on 4 April 2019	Not applicable.
02B – TRG Submissions Log as at 22 March 2019	Submissions Log as at 22 March 2019 for all issues submitted to the Transition Resource Group for IFRS 17 Insurance Contracts	Not applicable
02C – Sweep issues	The Board was asked to consider additional issues that have arisen before finalising the Exposure Draft of proposed amendments to IFRS 17. The board revisited the scope of the previously proposed amendments on investment return services and 3 other items	Amend the previously agreed scope of when an investment return service can be present and clarify 2 other areas of IFRS 17
02D – Comment period for the forthcoming exposure draft	The Board was requested to set a comment period of 90 days for the forthcoming Exposure Draft of proposed amendments to IFRS 17	The Board agreed on a 90 day comment period

April 2019 TRG update

4. The IASB staff noted that some of the topics discussed by the TRG in April to some extent already had been considered by the Board in its April 2019 meeting. The IASB staff noted that no further TRG discussions were scheduled, although constituents could submit additional issues for consideration if they believe they meet the TRG submission criteria. It was noted that any stakeholder comments related to the proposed amendments should be included in their comment letters on the exposure draft.

Sweep issues

5. The staff identified four sweep issues for this meeting. A sweep issue is a technical matter identified during the balloting of a document that needs to be resolved by a discussion by the IASB or the Interpretations Committee in a public meeting.

Investment return service

6. The IASB agreed to revisit its previous decision relating to when an investment return service can be present. In January 2019 the IASB tentatively decided that, for insurance contracts for which an entity provides an investment return service, the contractual service margin (CSM) should be recognised in profit or loss on the basis of coverage units that are determined by considering both insurance coverage and investment-return service. The Board then agreed that an investment return service was only present when the contract includes an investment component, as defined in the Standard. However, staff noted that in certain instances, investment return services might be provided even when a contract did not have an investment component as defined in the Standard. One example in the staff paper is a deferred annuity contract where premiums are paid upfront and during the accumulation phase a return is earned. During that phase, the policyholder has the right to transfer the accumulated amount to another annuity provider or to receive the accumulated amount if he dies. The accumulated amount can be converted into an annuity at a fixed conversion rate at a future date. After conversion into an annuity, there is no period of guaranteed payments. That is,if the policyholder dies after conversion but before the first annuity payment, he receives nothing. As a result, there is no investment component because the policyholder does not receive repayment of the premium in all circumstances.

7. In its May 2019 meeting the IASB agreed that investment return services also could be present when an investment component does not exist. The IASB staff proposed that the standard should specify that an investment-return service exists if, and only if:

   (a) there is an investment component, or the policyholder has a right to withdraw an amount;

   (b) the investment component or amount the policyholder has a right to withdraw is expected to include a positive investment return; and

   (c) the entity expects to perform investment activity to generate that positive investment return.

   IASB staff noted that TRG members had been asked to comment on the sweep issue in advance of the Board meeting, and that their response mainly welcomed the amendment but some clarifications had been requested.

8. Several IASB members expressed concern that the proposal might appear to define a set of criteria that would be determinative that an investment service existed, whereas at the January meeting the Board had decided that judgement is required to determine whether an entity provides an investment return service where an investment component exists. One member asked whether reflecting just time value of money was enough to be a positive investment return, and the staff noted they had been discussing whether the standard should give more guidance and proposed not to. Several IASB members further questioned the meaning of a 'positive investment return' and suggested that it be clarified, preferably in the body of the revised Standard as opposed to the Basis for Conclusions. Specifically, members suggested it should be clarified that 'positive' should be viewed as a relative term (i.e. a positive benefit to the policyholder) rather than an absolute term. For example in a negative interest rate environment, a positive return might be a return that is less negative than returns available elsewhere considering the economic environment. It was agreed that IASB staff should consider the feedback from the Board in its drafting of the ED.

Other clarifications to insurance revenue

9. The IASB also agreed to propose clarifications for two of the other sweep issues:
   •Paragraph 103 of IFRS 17 currently requires an entity to separately disclose—in the reconciliation from the opening to the closing balances of the insurance contract liability — investment components excluded from insurance revenue and insurance service expenses. The amendment will revise the requirement to disclose 'investment components (and refunds of premiums unless presented as part of the cash flows in the period) excluded from insurance revenue and insurance service expenses.' That is, an entity is not required to separately distinguish between the amount of a premium refund and an investment component that is excluded from revenue and expense. Stakeholders had expressed concern that it would be difficult to determine what amount of a repayment to a policyholder represents a refund of premium versus an investment component.
   •An amendment related to insurance revenue, to clarify that changes resulting from cash flows of amounts lent to policyholders and waivers of amounts lent to policyholders are excluded from insurance revenue since paragraph B123 currently is silent on how such amounts are treated.

Mutual entities

10. The IASB agreed not to amend the Basis for Conclusions related to mutual entities issuing insurance contracts, despite several requests to do so. Instead, the staff will consider including a footnote to the paragraph within the Basis for Conclusions to IFRS 17 noting that different definitions of mutual entities might be applied in practice, and that some entities that are described as mutual entities may not be required to pay all residual returns to policyholders.

11. In some paragraphs in the Basis for Conclusions of IFRS 17 it is noted that for a mutual entity the most residual interest of the entity is owed to policyholders and not shareholders. Consequently those cash flows are part of the fulfilment cash flows and normally there would be no equity for such entities. Stakeholders have noted that such presentation in their mind would not depict the economic reality in certain fact patterns. One Board member noted that in certain situations not all proceeds will go to policyholders due to capital requirements from regulators, and that in this situation the accounting should be clarified.

12. Some Board members expressed sympathy for the stakeholder's concerns acknowledging that there might be different variations of mutual entities as noted above, and therefore agreed with the suggestion to add a footnote to this effect. Other Board members noted that making any further changes to the wording in the Basis for Conclusions may lead to an incorrect interpretation of the requirements of the standard. The Board emphasised that one of the main objectives of IFRS 17 is to account for insurance contracts based on their features, regardless of the characteristics of entity which issues them. Therefore, they did not believe any further changes to the Basis for Conclusions were warranted.

90 day comment period for the forthcoming exposure draft -of amendments to IFRS 17

13. Board members agreed that the comment period for the forthcoming exposure draft should be 90 days, versus the normal 120 days, given that the targeted amendments are both urgent and narrow in scope. The IASB staff noted that approval for the shortened exposure period was granted from the Due Process Oversight Committee in April. The staff paper notes that the 90 day comment period balances the need to allow sufficient time for stakeholders to consider and respond to the targeted amendments with the need to provide clarity about the proposed amendments on a timely basis. This 90 day period is consistent with the comment period for the narrow scope amendments in IFRS 15. The staff paper further notes that a 90 day period would minimise disruption, as it would facilitate the issuance of the amendments to IFRS 17 in the second quarter of 2020 and thereby allow sufficient time until the proposed effective date of 1 Jan 2022.

Next steps

14. The staff will continue the process of drafting an exposure draft on the amendments including the annual improvements to IFRS 17.

15. The previously communicated timeline has not changed, and the staff expect to publish an exposure draft of proposed amendments to IFRS 17 at the end of June 2019.

Word on the Wharf

The board met on Tuesday 14 to Thursday 16 May 2019 at the IFRS Foundation's Offices in London.

The topics, in order of discussion, were:

- Provisions
- Implementation matters
- Primary Financial Statements
- Amendments to IFRS 17 Insurance Contracts
- Disclosure Initiative
- Management Commentary
- Review of the IFRS for SMEs Standard
- Rate-regulated Activities
- Goodwill and Impairment

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190603-095233-OP-OS