THE BOTTOM LINE

Issue 9

Welcome to the latest edition of our financial reporting publication that aims to keep you in the loop with all the latest accounting and financial reporting developments, and the potential impact they may have on your business.

The accounting for an asset acquisition is very different to the accounting for a business combination so identifying what has been acquired, and getting this right, is important. On this note, we explore recent accounting amendments that aim to make this assessment a little easier. There have been a few international developments that will soon make their way to Australia, the main one relating to the recent extension of the relief relating to COVID-19-related rent concessions for lessees. And finally, we point entities to the latest 'no action' positions made by ASIC relating to the convening and holding of AGMs.

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What has been acquired: an asset or a business?

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In the accounting world, this is a common question. Fortunately, recent amendments to the accounting standard dealing with business combinations, namely AASB 3, should go some way in easing the complexity involved in assessing whether an asset or a business has been acquired in a transaction.

The amendments come after the International Accounting Standards Board (IASB) completed its post-implementation review of the international standard, IFRS 3, in 2015. Stakeholders raised concerns about the broad definition of a 'business', which made it difficult to interpret and apply this definition in practice. The feedback called for guidance in assessing the relevance of any processes acquired, the significance of any missing processes, and how to apply the definition of a business when no revenue is being generated by an acquired entity.

In addition to addressing the above concepts, the revisions to IFRS 3 / AASB 3 include an optional 'fair value concentration test' that allows for a simplified assessment of whether an acquired set of activities and assets is not a business.

Distinction between 'asset' and 'business' is important

The accounting for business combinations under AASB 3 differs from the accounting for asset acquisitions (which fall outside the scope of AASB 3).

One of the key differences is that business combinations may give rise to goodwill while asset acquisitions do not. This is because with a business combination, assets and liabilities acquired are accounted for at their fair values on acquisition date. In contrast, an asset purchase is accounted for by allocating the transaction price to the individual assets and liabilities acquired based on their relative fair values on date of purchase.

Another key difference is that directly attributable transaction costs are expensed when accounting for a business combination, while such costs are capitalised as part of the cost of the asset in the case of an asset acquisition.

The differences in the treatment of a business combination and an asset acquisition will not only affect the acquisition date accounting but will also have an impact on future depreciation and possible impairment. Furthermore, disclosures are more arduous for business combinations.

Refined definition of 'business' and 'outputs'

The table below shows how the definition of 'business' has been revised under the amendments to AASB 3:

Previous definition of business	Revised definition of business
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 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.

As can be seen in the above definitions, the meaning of outputs has been narrowed to focus on goods or services provided to customers, investment income or other income from ordinary activities. The previous reference to 'lower costs or other economic benefits' was not overly helpful in distinguishing between an asset and a business as an acquired asset may also provide a return in the form of lower costs or other economic benefits. It was therefore removed from the definition of a business and the definition of outputs.

Minimum requirements for a business

The existence of a process (or processes) is what differentiates a business from a set of activities and assets that is not a business. Thus, to be considered a business, an acquired set of activities and assets must include, as a minimum, an input and a substantive process that together significantly contribute to the creation of outputs. This also makes it clearer that a business can exist without *all* the inputs and processes needed to create outputs being present, as long as the inputs and processes acquired can collectively significantly *contribute* to the generation of outputs.

The amendments to AASB 3 also recognise that, while most businesses do generate outputs, outputs are not a prerequisite for an integrated set of activities and assets to qualify as a business.

What is a 'substantive' process?

New guidance and illustrative examples have been added to AASB 3 to assist entities in assessing

whether an acquired process is substantive. This guidance requires more persuasive evidence when there are no outputs because the existence of outputs already provides some evidence that the acquired set of activities and assets is a business. An example of an acquired set of activities and assets that does not have outputs is a new entity that has not yet generated revenue.

Where a set of activities and assets does not have outputs at the acquisition date, the acquired process is substantive only if:

- it is critical to the ability to develop or convert an acquired input into outputs; and
- the inputs acquired include both:
  - » an organised workforce that has the skills, knowledge, or experience to perform that process; and
  - » other inputs that the organised workforce could develop or convert into outputs, such as technology, in-process research and development projects, real estate interests and mineral interests.

The above guidance implies that an organised workforce is generally key to identifying a business. There is, however, a carve-out for situations where the acquired set of activities and assets does have outputs, and includes a process that is unique or scarce, or cannot be replaced without significant cost, effort or delay in producing outputs, as this would most likely indicate the acquired process is substantive despite the absence of an organised workforce.

An acquired contract is not itself a substantive process. However, an acquired contract, such as a contract for outsourced property management or outsourced asset management, may give access to an organised workforce and therefore a substantive process. This would be evaluated based on factors such as the contract's duration and renewal terms.

Optional concentration test

Applying the definition of a business often involves significant judgement, and prior to the amendments discussed in this article, there was little or no guidance in AASB 3 that identified situations in which an acquired set of activities and assets is not a business. Accordingly, an optional fair value concentration has been introduced to AASB 3 which provides a simplified way of concluding that an acquisition is not a business combination. Entities can choose whether or not to apply this test on a transaction-by-transaction basis.

If the test is passed, it is concluded that the acquisition is not a business and no further assessment is required, regardless of any other factors or considerations. If the test is not met, or an entity decides not to perform the test, the usual assessment that determines whether or not an acquired set of activities and assets meets the definition of a business needs to be carried out. As such, the concentration test never determines that a transaction is a business combination.

AASB 3 explains that the optional concentration test is met if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. The test is based on gross, not net, assets as many businesses have liabilities but do not need them to be considered a business. Likewise, an acquired set that is not a business may have liabilities. In addition, certain assets are excluded from the gross assets considered in the test.

Assessing if substantially all the fair value is concentrated in a single identifiable asset, or group of similar identifiable assets, will require the use of judgement. Furthermore, there are specific rules that need to be applied when performing the concentration test. These are set out in AASB 3.B7B and are summarised as follows:

- Cash and cash equivalents, deferred tax assets and goodwill arising from the effects of deferred tax liabilities must be excluded from gross assets.
- A single identifiable asset must include any asset or group of assets that would be recognised and measured as a single identifiable asset in a business combination.
- A single identifiable asset includes assets that are attached or cannot be removed from other assets without incurring significant cost or loss of value of either asset (e.g. land and buildings).
- Assets are grouped (to form a group of similar identifiable assets) based on whether they are similar in nature and have similar risks associated with managing and creating outputs from the assets.
- Certain assets cannot be considered to be similar assets such as:
  - » a tangible asset and an intangible asset
  - » tangible assets in different classes
  - » intangible assets in different classes
  - » a financial asset and a non-financial asset
  - » financial assets in different classes
  - » identifiable assets within the same class of asset but that have significantly different risk characteristics.

Effective date of amendments

Important to note is that the revisions to AASB 3 are already effective. They apply to all business combinations and asset acquisitions with an acquisition date that is on or after the beginning of the first annual reporting period on or after 1 January 2020. Consequently, entities do not have to revisit these types of transactions that occurred in previous periods.

Example: Determining the fair value of the gross assets acquired

Fact pattern

Entity A holds a 40% interest in Entity X. Subsequently, on acquisition date, Entity A purchases a further 35% interest in Entity X, thereby obtaining control of Entity X. Entity X has the following assets and liabilities as at acquisition date:

- a building with a fair value of 500
- an identifiable intangible asset with a fair value of 50
- cash and cash equivalents with a fair value of 100
- deferred tax assets of 200
- financial liabilities with a fair value of 600
- deferred tax liabilities of 150 arising from temporary differences associated with the warehouse and the intangible asset.

Entity A pays 210 for the additional 35% interest in Entity X. The acquisition-date fair value of Entity X is determined to be 600, the fair value of the non-controlling interest (NCI) in Entity X is 150 (25% x 600) and the fair value of Entity A's previously held interest in Entity X is 240 (40% x 600).

Analysis

Should Entity A elect to perform the concentration test, it would need to determine the fair value of the gross assets acquired. This is determined to be 900, calculated using either of the following methods:

	Method 1		Method 2
	Fair value of consideration transferred (210)		Fair value of identifiable assets acquired, excluding cash and deferred tax assets (500 + 50 = 550)
PLUS	Fair value of the NCI (150)	PLUS	The sum (350) of:
PLUS	Fair value of the previously held interest (240)		Fair value of consideration transferred (210)
PLUS	Fair value of liabilities assumed (other than deferred tax liabilities) (600)		+ Fair value of the NCI (150)
LESS	Cash and cash equivalents (100)		+ Fair value of the previously held interest (240)
LESS	Deferred tax assets acquired* (200)		- Fair value of the net identifiable assets acquired
			(500 + 50 + 100 + 200 – 600 = 250)

** In practice, deferred tax assets would only be excluded if including the deferred tax assets could lead to the concentration test not being met*

The excess of the sum of the fair value of Entity X over the fair value of the net identifiable assets calculated in Method 2 above (i.e. 350) is determined in a manner similar to the initial measurement of goodwill in accordance with AASB 3. Including this amount in determining the fair value of the gross assets acquired means that the concentration test is based on an amount that is affected by the value of any substantive processes acquired.

Furthermore, the fair value of the gross assets acquired determined using Method 2 above (i.e. 550) excludes cash and cash equivalents (100) and deferred tax assets (200) as these items are independent of whether any substantive process was acquired. Also, the deferred tax liability is not deducted in determining the fair value of the net assets acquired (250) and does not need to be determined. As a result, the excess (350) calculated above does not include goodwill resulting from the effects of deferred tax liabilities.

Refer to the Illustrative Examples included as part of the amendments to AASB 3 for examples of when the concentration test could be met and how to apply the concepts clarified under the revisions to the standard.

ACNC publishes best practice disclosures

The Australian Charities and Not-for-profits Commission (ACNC) has issued what it views to be best practice disclosures when it comes to government funding as a source of revenue for charities.

Based on the Australian Charities Report 2018, it is apparent that a significant chunk of the charity sector's revenue comes from government. Application of the recommended disclosures will assist in providing users of charity financial reports with useful and consistent information, as well as help promote transparency and accountability in the sector.

The ACNC recommends that three disclosures relating to government funding be made in the notes to the financial statements. These disclosures are:

- Information about the sources of government revenue;
- Economic dependency on government revenue; and
- Funding received from government but not yet recognised as revenue.

Sources of government revenue

Where revenue from government sources (including grants) constitutes 10% or more of a charity's total revenue, it is recommended that the following be disclosed regarding the sources of its government revenue:

- Total revenue received from each level of government (such as the Commonwealth, state, or local governments);
- Names of the government departments or agencies from which it received revenue (up to a maximum of 10), as well as the total amounts received from each;
- Revenue from providing goods or services to beneficiaries who receive related government financial assistance.

The ACNC guidance states that revenue from government would include:

- Government grants
- Revenue received under a contract with government to provide goods and services
- Government rebates, supplements, subsidies or funds for programs
- Revenue received from direct sales or delivery of programs to beneficiaries if the revenue is ultimately funded by government, where this information is readily available (e.g. National Disability Insurance Scheme payments, or home and community care services).

Economic dependency on government revenue

Some charities are very reliant on government funding for their continued existence. For such charities, an economic dependency note would be important for users, especially to understand the consequences if that government funding were to no longer be received.

An assessment by the charity's management regarding the likelihood of the continued economic support should be included in the economic dependency note, as well as any other judgements and assumptions made by management when considering the charity's economic reliance.

Where material uncertainties exist about the revenue from government that cast significant doubt on the charity's ability to continue as a going concern, the disclosures required by AASB 101 *Presentation of Financial Statements* must be made.

Government funding not yet recognised as revenue

This recommendation applies to those charities that prepare special purpose financial statements and do not comply with all the disclosure requirements of AASB 15 *Revenue* and AASB 1058 *Income of Not-for-profit Entities*.

The ACNC recommends that revenue received in advance from government should be disclosed separately from other revenue received in advance. Furthermore, it is suggested that cash receipts from government be shown separately from cash receipts from other sources in the cash flow statement.

As emphasised by the ACNC in its guidance, the recommended disclosures do not replace any existing disclosure requirements of Australian Accounting Standards. Rather, the aim is to encourage widespread use of meaningful and consistent disclosures by all charities, which will also improve the comparability of financial information available on the ACNC Charity Register.

Extension of relief for COVID-19-related rent concessions

In response to calls from stakeholders and the ongoing effects of the pandemic, the International Accounting Standards Board (IASB) has approved a one-year extension to the practical expedient for COVID-19-related rent concessions allowed under IFRS 16 *Leases*.

In May 2020, the IASB amended IFRS 16 (the international equivalent to AASB 16) to introduce an optional practical expedient to simplify how a lessee accounts for rent concessions arising as a direct consequence of the pandemic. Applying the practical expedient means lessees are not required to assess whether eligible rent concessions are lease modifications. Rather, such rent concessions are effectively treated as variable lease payments in the period in which the event or condition that triggers those payments occurs.

Under the May 2020 amendment, application of the practical expedient is conditional on COVID-19-related rent concessions meeting all of the following requirements:

- The revised consideration for the lease is substantially the same as, or less than, the original consideration;
- The reduction in lease payments relates to payments originally due on or before 30 June 2021; and
- There are no other substantive changes to the terms and conditions of the lease.

At a supplementary meeting in February 2021, the IASB deliberated changing the date in the second bullet point above to 30 June 2022, thereby extending the relief available to lessees by 12 months at a time when the pandemic is at its peak. The proposal was then tentatively approved at another supplementary meeting on 10 March 2021.

At the time of writing, the amending standard is expected to be finalised by the end of March and would be effective for annual reporting periods beginning on or after 1 April 2021. Lessees would be able to apply the amendment early, including in financial statements not yet authorised for issue at the date the amendment is issued. In Australia, once the Australian Accounting Standards Board (AASB) has endorsed the amendment, it would be available for immediate use by local entities.

While the May 2020 amendment that introduced the practical expedient was (and still is) optional, the new amendment that purely extends the scope of the practical expedient is, in effect, not optional. This is because of the requirement to apply the expedient consistently to all lease contracts with similar characteristics and in similar circumstances. Accordingly, a lessee that has already applied the practical expedient must also apply the extended scope of the practical expedient. Similarly, the latest amendment does not allow a lessee to elect to apply the practical expedient if the lessee has previously elected not to apply it to eligible rent concessions. This is to preserve comparability of reported information, reduce complexity and avoid unintended consequences.

A potential consequence of the preceding paragraph is that some lessees may need to reverse previous lease modification accounting if a rent concession did not qualify for the original practical expedient but becomes eligible as a result of the scope extension.

The amendment to IFRS 16 would be applied on a retrospective basis with the cumulative effect of initial application being recognised in opening retained earnings (or other component of equity, as appropriate) at the beginning of the annual reporting period in which the amendment is first applied. This modified retrospective transition approach would alleviate some of the effort required to undo previous lease modification accounting if the scenario in the preceding paragraph were to apply.

Amendments to improve accounting policy disclosures

Narrow-scope amendments have recently been made to IAS 1 *Presentation of Financial Statements* and IFRS Practice Statement 2 *Making Materiality Judgements* that aim to improve accounting policy disclosures by requiring entities to disclose their 'material' accounting policies rather than their 'significant' accounting policies.

Currently, IAS 1 *Presentation of Financial Statements* requires entities to disclose their significant accounting policies. Divergent views as to what constitutes a significant accounting policy has led to ineffective accounting policy disclosures in practice. This often leads to lengthy financial reports that contain excessive and irrelevant information, information that is not entity-specific enough, or too much information that obscures important information.

In making the amendments, the IASB concluded that the concept of materiality, which is already defined in IFRS, could be applied when deciding which accounting policies to include in the financial report. Accounting policy information is material if, when considered together with other information included in an entity's financial statements, it can reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements.

The revised standard goes on to explain that accounting policy information that relates to immaterial transactions, other events or conditions need not be disclosed on the basis that it is immaterial. However, not all accounting policy information relating to material transactions, other events or conditions is itself material. For example, standardised information or information that only replicates or summarises the requirements of IFRS are less useful to financial statement users.

Guidance has been added to IAS 1 to explain that accounting information is likely to be material if it relates to material transactions, other events or conditions, and the accounting policy:

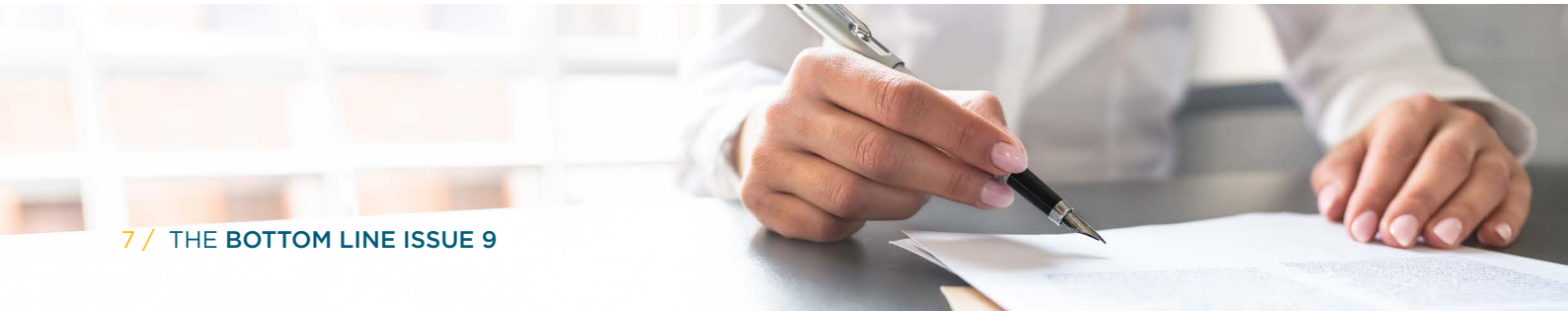
- Has changed during the period
- Is one of a choice of options allowed under IFRS (e.g. measuring property, plant and equipment at cost or fair value)
- Has been developed by using the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in the absence of specific IFRS requirements that apply in the circumstances
- Requires the use of significant judgements or assumptions in its application, or
- Pertains to complex accounting and users would otherwise not understand the material transaction.

The clarifications make it clear that if an entity chooses to disclose immaterial accounting policy information, such information must not obscure material accounting policy information.

The amendments to IAS 1 do not affect the disclosures required to be made under other IFRS standards. For example, an entity may conclude that it has no material accounting policy information to disclose regarding investment property, however, if material, the entity must still disclose the information required by IAS 40 *Investment Property*.

To support the amendments, IFRS Practice Statement 2 has been revised to demonstrate how an entity could decide whether information about an accounting policy is material to its financial statements. Guidance and examples have been added to Practice Statement 2 to assist entities in apply its 'four-step materiality process' to accounting policy disclosures.

The above amendments are effective for annual periods beginning on or after 1 January 2023, however, entities can (and are encouraged to) adopt the changes earlier once the amendments have been authorised for use by the local accounting body (such as the Australian Accounting Standards Board). The changes are to be applied on a prospective basis.



Accounting estimates defined

Distinguishing between a change in accounting policy and a change in accounting estimate can sometimes be challenging. The IASB has recently introduced a new definition for 'accounting estimates' that should make it easier for entities to make this distinction.

The distinction is important as a change in accounting policy is generally applied retrospectively whereas a change in an accounting estimate is accounted for on a prospective basis.

Prior to the amendments to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, the standard contained a definition for 'accounting policies' and a definition for a 'change in accounting estimates'. The combination of a definition of one item (accounting policies) with a definition of a change in another item (change in accounting estimates) has often made it challenging to differentiate between the two.

Under the revisions to IAS 8, accounting estimates are now defined as 'monetary amounts in financial statements that are subject to measurement uncertainty'. The standard was also amended to explain that accounting policies may require items in financial statements to be measured in a way that involves measurement uncertainty. That is, the accounting policy may require such items to be measured at monetary amounts that cannot be observed directly and must instead be estimated. In such cases, an entity develops an accounting estimate to achieve the objective set out by the accounting policy. This typically involve the use of judgements or assumptions based on the latest available reliable information.

The following examples of accounting estimates is listed in the revised standard:

- Expected credit loss allowance
- Net realisable value of inventories
- Fair value of an asset or liability
- Depreciation expense
- Provision for warranty obligations

The amendments clarify how entities use measurement techniques and inputs to develop accounting estimates and states that these can include estimation techniques (for example, to estimate expected credit losses) and valuation techniques (for example, to measure the fair value of an asset).

While the definition of a change in accounting estimates has been removed from IAS 8, the concept of such changes has been retained with the following clarifications:

- A change in accounting estimate that results from new information or new developments does not constitute a correction of an error.
- The effects of a change in an input or a measurement technique used to develop an accounting estimate are changes in accounting estimates if they do not result from the correction of prior period errors.

The amendments become effective for annual reporting periods beginning on or after 1 January 2023 and apply to changes in accounting policies and changes in accounting estimates that occur on or after the start of that period. Earlier application is permitted.

"Distinguishing between a change in accounting policy and a change in accounting estimate is important as the former is generally applied retrospectively while the latter is applied on a prospective basis."

ASIC issues 'no action' position for AGMs

The COVID-19 relief measures that amended the Corporations Act to allow companies to hold their Annual General Meetings virtually lapsed on 21 March 2021. The Australian Securities and Investments Commission (ASIC) has adopted a temporary 'no action' position in relation to the convening and holding of virtual meetings in a move to provide businesses with some degree of certainty while legislation that would extend the relief measures waits to be debated in the Senate.

ASIC's no action position was announced on 29 March 2021 and does the following:

- Supports the holding of AGMs and other required meetings using appropriate technology;
- Facilitates electronic notice of meetings, including supplementary notices; and
- Extends the two-month 'deferral' of AGMs to more public companies.

Holding meetings virtually

ASIC will not take any action where an entity elects to hold a meeting using virtual technology, despite the provisions in the Corporations Act that restrict such meetings.

This no action position applies to meetings held between 21 March 2021 and the earlier of:

- 31 October 2021; and
- The date that Parliament passes any measures relating to the use of virtual technology in meetings of companies or managed investment schemes.

Importantly, ASIC's no action position on virtual meetings is conditional. Entities relying on this no action position should make sure they are aware of the conditions, and also consider the guidance ASIC issued on hosting virtual meetings.

Convening meetings electronically

ASIC will also take no action where an entity contravenes the Corporations Act by sending notice of a meeting, or supplementary information relating to a meeting, via electronic means to those entitled to receive notice of the meeting.

This no action position applies to meetings held between 21 March 2021 and the earlier of:

- 31 October 2021; and
- The date that Parliament passes any measures relating to the use of virtual technology in meetings of companies or managed investment schemes.

Again, there are conditions attached to the no action position which are detailed in ASIC's media release.

Two-month 'deferral' of AGMs

ASIC will not take action against a public company with a financial year end of between 7 January 2021 and 7 April 2021 that does not hold its AGM within five months of year end, provided the AGM is held within seven months of year end. As ASIC's announcement explains, this builds on the existing equivalent no-action position that applies to public companies with financial years that ended from 31 December 2019 to 7 January 2021.

Financial reporting relief remains unchanged for now

There is currently a one-month extension available to listed and unlisted entities to lodge financial reports under Chapters 2M and 7 of the Corporations Act. This extension currently applies to entities with financial years that end between 21 February 2020 and 7 January 2021.

While ASIC has given the above no action position for AGMs up to financial years ending 7 April 2021, there is no current intention to extend the existing lodgement relief for financial reports of listed and unlisted entities with balance dates that end between 8 January 2021 and 7 April 2021. Entities can, however, apply individually to ASIC for an extension of their financial reporting deadline, should their circumstances require this.

Please refer to ASIC's media release for more details on the latest no action positions.

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