IFRS IN PRACTICE

Distinguishing between a business combination and an asset purchase in the extractives industry

TABLE OF CONTENTS

1. INTRODUCTION

A critical step in determining the appropriate accounting approach to be followed for an acquisition transaction in the extractives sector is to determine whether the acquisition is of a business (and therefore within the scope of IFRS 3 *Business Combinations*), or is of an asset or group of assets that do not constitute a business and is therefore outside the scope of IFRS 3.

Major differences between the accounting requirements for a business combination accounted for in accordance with IFRS 3, and an asset acquisition, are set out below:

	Acquisition of a business	Acquisition of an asset
Goodwill	Goodwill or bargain purchase gain recognised.	No goodwill or bargain purchase gain recognised.
Initial measurement of assets and liabilities	Assets and liabilities acquired are accounted for at their fair values.	Assets and liabilities are assigned a carrying amount based on relative fair values.
Transaction costs	Transaction costs are expensed.	Transaction costs are capitalised.
Deferred taxes	Deferred tax assets and liabilities arise if tax base is different from the accounting base.	Initial recognition exemption in IAS 12 *Income Taxes* is applied so no deferred tax assets and liabilities arise if the tax base is different from the accounting base.
Non-controlling interest (NCI)	Non-controlling Interest (NCI) if the business is not majority owned.	No NCI if the acquisition is not of an entity that is to be consolidated in accordance with IFRS 10 *Consolidated Financial Statements*.
Consideration paid in the form of equity instruments ***(That meets the definition of an equity instrument)***	Consideration paid in the form of equity instruments, in a way that meets the definition of equity from the acquirer's perspective, is measured at the fair value of the equity instruments at the point control is obtained.	Consideration paid in the form of equity instruments is a share based payment within the scope of IFRS 2 *Share-based Payment* and the measurement is determined by reference to the fair value of the asset acquired.
Consideration paid in the form of equity instruments ***(That does not meet the definition of an equity instrument)***	Consideration paid in the form of equity instruments that does not meet the definition of equity is determined at the fair value of the shares at point control is obtained and is remeasured to fair value at each reporting date until settled (with changes in fair value being recorded in profit or loss).	Consideration paid, for the acquisition of an asset, in the form of equity instruments is a share-based payment within the scope of IFRS 2 and is not subsequently remeasured.

	Acquisition of a business	Acquisition of an asset
Contingent consideration	Contingent consideration (including royalty streams) is a financial instrument, and should be accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*.	Contingent consideration (including royalty streams) is not automatically classified as a financial instrument, and might be accounted for as a contingent liability/provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or, in the case of royalty streams, may be determined to be executory in nature and outside of the scope of IAS 37.
Changes in the fair value of contingent consideration	After initial recognition at the acquisition date fair value, changes in the fair value of contingent consideration is recognised in profit or loss.	IFRS is not clear about the accounting approach to be followed for the movement in the fair value of contingent consideration for an asset acquisition. Depending on the circumstances, movements in the carrying amount of contingent consideration may be either: – Recognised in profit or loss, or – Capitalised as part of the asset.

Figure 1: Significant differences between the accounting for a business combination compared with the accounting for an asset acquisition

2. WHAT IS A BUSINESS?

A business is defined in IFRS 3 *Business Combinations* as:

> *'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.' (IFRS 3 Appendix A).*

IFRS 3.2(b) excludes asset acquisitions that do not meet the definition of a business from its scope. IFRS 3.2 notes that:

> *'…This IFRS does not apply to…*
>
> *(b) the acquisition of an asset or a group of asset that does not constitute a business…'*

A business usually consists of:

- Inputs
- Processes
- Outputs.

Inputs and processes are the essential elements that have to be present in order to be classified as a business. Although a business usually has outputs, outputs are not required for an integrated set of assets to qualify as a business.

The elements of a business are described in IFRS 3.B7 as follows:

'Inputs' are described in IFRS 3.B7(a) as:

> *'Any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it. Examples include non-current assets (including intangible assets or rights to use non-current assets), intellectual property, the ability to obtain access to necessary materials or rights and employees.'*

'Processes' are described in IFRS 3.B7(b) as:

> *'Any system, standard, protocol, convention or rule that when applied to an input or inputs, creates or has the ability to create outputs. Examples include strategic management processes, operational processes and resource management processes. These processes typically are documented, but an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. (Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs.)'*

'Outputs' are described in IFRS 3.B7(c) as:

> *'The result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.'*

Differentiating a business from an asset acquisition is key to applying an appropriate accounting treatment for acquisitions of operations in the exploration, development and pre-production phases. This will involve a good degree of professional judgement and a detailed analysis of what inputs and processes have been acquired, and which missing elements can readily be added by an acquirer (whether directly or through purchase from third parties). To assist in determining whether an acquired set of assets and liabilities meets the definition of a business, IFRS 3 contains application guidance in Appendix B.7-12.

BDO comment

From the definition of a business in IFRS 3 above, the following observations can be made:

- *Acquisitions of entities/projects involved solely in exploration and evaluation (E&E) activities are likely to be asset acquisitions, not business combinations, although care will be required for entities/projects for which E&E work has been carried out and, in addition, there are proven and probable reserves and a plan for site development (even if development work has not yet commenced)*
- *Acquisitions of entities/projects in the development phase will require careful analysis, but these are likely to constitute a business combination*
- *Acquisitions of entities/projects in the production phase are likely to constitute a business combination.*

This analysis is based on the characteristics of activities in the extractive sector, because the ultimate output is the mined commodity. This means that in order for the acquisition to be classified as a business, the acquired set of assets and processes should be capable of producing the intended output.

However, because an operation that is capable of (as well as one which is already) operating as a business falls within the definition of a business, it is not necessary for the output to be in production at the acquisition date. Consequently, given that the output is determined to be the mined commodity, the inputs need to include at least proven and probable reserves and the processes should include a mine/production plan. Practical issues may also arise when an acquired entity holds projects in varying phases of their project life cycle (exploration projects and producing mines).

3. DO ACTIVITIES NEED TO INCLUDE ALL INPUTS AND PROCESSES TO BE A BUSINESS?

The two essential elements required to be classified as a business are inputs and processes. However the integrated set of assets acquired do not have to include all of the inputs and processes necessary to produce an output.

IFRS 3 *Business Combinations* (IFRS 3.B8) notes that:

> *'To be capable of being conducted and managed as a business, an integrated set of activities and assets requires two essential elements – inputs and processes applied to those inputs, which together are or will be used to create outputs. However, a business need not include all of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, e.g. by integrating the business with their own inputs and processes.'*

BDO comment

If certain aspects of one or more of the elements are missing, this does not mean that the group of assets and liabilities under consideration automatically fails the definition of a business. The question which needs to be addressed is whether an entity that might acquire the group of assets and liabilities could add or replace the missing elements through integration into its own operations, or from a third party supplier. This is relevant for operations acquired from some entities that carry out exploration and evaluation (E&E) activities, but have no intention of carrying out work in the development stage; their business model is to carry out E&E activities and derive the added value through sale, and not physical development. If those E&E activities have progressed to a stage at which there are proven and probable reserves, it is necessary to consider whether a potential acquirer could operate the activities as a business. The easier it would be for the missing elements to be obtained in a relatively short period of time, the more likely it will be that the activities will meet the definition of a business.

Some argue that the focus should be on the return that an entity expects to derive from its activities, when determining whether its assets, liabilities and activities (or components thereof) represent a business. For example, it is sometimes suggested that, from the perspective of entities that will only ever carry out E&E activities and generate added value through their sale, the outputs from the assets, liabilities and activities that they own should be regarded as being the resultant dividend streams that will be generated. However, that seems a difficult argument to support and appears to confuse the activities and outputs of the parent (or owner of the business(es)), which are to derive value from E&E activities that are applied to various mining assets, and the activities and outputs of the mining assets themselves. This distinction is illustrated in example 3 below.

Example 1 : Acquisition of a company that owns a producing mine

Company A has a long established producing mine.

It has an established processing facility and a rail head.

Company B owns a single producing mine.

Company A acquires 100% of the share capital of Company B.

Company A acquires:

– Inputs: Mineral rights, mining equipment, processing equipment, storage equipment, access to transportation
– Processes: Mine plan. processing plan, rehabilitation plan, logistics/transportation, in place skilled workforce
– Outputs: Processed ore.

Analysis

The acquisition meets the definition of a business.

Example 1A : Acquisition of a producing mine (not the acquisition of a company)

Company A has a long established producing mine.

It has an established processing facility and a railhead.

Company B owns three producing mines (mine A, B and C).

Company A acquires Mine A from Company B, as an 'asset acquisition', taking over all property, plant and equipment (PP&E).

The workforce operating Mine A transfers to Company B.

Company A does not acquire any shares or any legal entity.

Company A acquires:

– Inputs: Mineral rights, mining equipment, processing equipment, storage equipment and access to transportation
– Processes: Mine/processing plan, rehabilitation plan, logistics/transportation and in-placed skilled workforce
– Outputs: Processed ore.

Analysis

The acquisition meets the definition of a business.

The fact that Company A acquired the mine rather than shares in a company that owns the mine is irrelevant in the determination as to whether the transaction is within the scope of IFRS 3.

Example 2 : Acquiring a company that does not include all inputs or processes

Company A is a junior producer that owns a single mine site.

It operates as a 'virtual' producer, sub-contracting all mining and operating activity to a third party, including the supply of mining equipment.

It also uses the railhead and logistics capability of its larger neighbour Company B.

Company C acquires Company A.

Company C acquires:

- Inputs: Mineral rights and geological data are held directly by Company A. All PP&E is made available by third parties (mining equipment by the third party operator and railhead and logistics capability by Company B)
- Processes: Mine plan subcontracted to the third party operator
- Outputs: Processed ore.

Analysis

Company A does not itself have directly held processes and lacks some inputs (such as mining equipment).

However, these are effectively held by Company A, because Company A directs the activities of the subcontractor via the mine plan.

Consequently, Company A is viewed as being the principal over the processes and inputs that are attributable to the subcontractor, and treats them as if it they are its own.

This means that Company C has acquired a business.

Questions also arise about what is meant by 'outputs'. In particular, are these the outputs which will ultimately be produced from a mining operation, or can outputs be viewed more widely?

Example 3 : Acquisition of a mining tenement adjoining a producing mine

Company A has a long established gold mine located in Australia, with an established processing facility and a rail head.

Company B owns the mineral rights to a prospective gold deposit in West Africa.

Company B has undertaken limited geological work, and has not yet determined either reserves or resources.

All geological work has been outsourced.

Company B employs no geologists directly, instead using a third party to performing drilling and exploration activities.

Company A acquires 100% of the share capital of Company B.

Company A acquires:

- Inputs: exploration licence for a specified area (no proven and probable reserves) and limited geological data
- Processes: Outsourced exploration plan (Note that plan is with third party geologists)
- Outputs: None.

Analysis

The acquisition does not include proven and probable reserves, nor is there a bankable feasibility study (FS), mine plan or mining equipment. It would therefore appear to be lacking the necessary inputs and processes to generate the desired outputs and hence the transaction is presumed to be an asset acquisition.

Some argue that if Company A was in the business of generating profits from trading in mineral tenements with enhanced geological data, there would appear to be an input (the exploration licence). However, although all facts and circumstances need to be considered, this does not seem to be a strong argument; while Company A would have this business model, under which it would generate profits from the purchase of assets, which it enhances and sells to third parties. From the perspective of an entity acquiring those enhanced assets, this brings the focus back to the extent to which the work carried out by Company A on those assets results in them being an enhanced set of activities, assets and liabilities having the characteristics in IFRS 3.B10 (see section 4). In the example above, it would appear that insufficient progress has been made, and hence the transaction would be classified as an asset acquisition.

The determination of whether a set of acquired integrated assets meets the definition of a business is not dependent upon how the vendor has used (or uses) that set of integrated assets. IFRS 3.B11 notes that:

> *'Determining whether a particular set of assets and activities is a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Thus, in evaluating whether a particular set is a business, it is not relevant whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business.'*

Example 4 : Acquisition of an early exploration mining tenement

Company A is a geological consulting business.

It acquires the back office geological/exploration department from Big Miner Ltd, a large mining company, for CU1million.

The transaction involves the purchase of the data held by the department, including specialist modelling tools, together with the hardware and software to enable the geologists to perform their work.

The entire workforce of the department transfers to Company A, with Company A taking over all associated employment liabilities.

The geological consulting business was an internal department within Big Miner, which did not sell services to any third parties. Subsequent to acquisition Company A, will contract the services of these geologists back to Big Miner as well as integrating the acquired division into its ongoing business operations. The former team from Big Miner is particularly strong in exploration in the Greenstone belt in West Africa, an area where Company A was previously weak.

Company A acquires:

- Inputs: Geological data, modelling knowledge and skilled work force
- Processes: Exploration knowledge, consulting knowledge. geological evaluation and certification/quantification of proven and probable reserves
- Outputs: Geological reports and consulting reports.

Analysis

The acquisition is a business combination, having inputs, processes and outputs.

The fact that Big Miner did not previously sell the services of this department to third parties is not relevant in the analysis.

4. CAN ACTIVITIES WITH NO OUTPUTS BE A BUSINESS?

Entities that are in their development stage, including operations in the extractives sector that involve exploration and evaluation (E&E) activities, typically have no outputs. IFRS 3 *Business Combinations* includes guidance to assist in determining whether an entity without outputs is a business (IFRS 3.B10):

> *'An integrated set of activities and assets in the development stage might not have outputs. If not, the acquirer should consider other factors to determine whether the set is a business. Those factors include, but are not limited to, whether the set:*
>
> *(a) Has begun planned principal activities;*
>
> *(b) Has employees, intellectual property and other inputs and processes that could be applied to those inputs;*
>
> *(c) Is pursuing a plan to produce outputs; and*
>
> *(d) Will be able to obtain access to customers that will purchase the outputs.*
>
> *Not all of those factors need to be present for a particular integrated set of activities and assets in the development stage to qualify as a business.'*

BDO comment
It is very common for explorers and junior mining entities not to have outputs, as they have not yet reached the production stage. Careful consideration will be required to determine whether the acquisition of assets not yet in production meets the definition of a business.

Example 5 : Acquisition of an entity with no current outputs

Company A, an established gold producer, acquires Company B.

Company B owns a mining licence and has produced a bankable feasibility study (FS).

It has undertaken sufficient drilling work so as to have a proven and probable reserve of gold but has yet to move into the development phase.

Company B has no workforce and has instead outsourced its E&E activities to specialist mining consultants.

These consultants have also been responsible for the preparation of the FS.

Company B was in the process of raising funds to commence development work.

Company A acquires:

- Inputs: Mineral rights and proven and probable reserve
- Processes: Bankable feasibility study
- Outputs: None (the planned output is gold).

Analysis

The acquisition includes a number of inputs and processes, but lacks a number of key inputs (such as mining equipment and a rail head) and includes no processes that could currently produce gold. However, this does not preclude classification as a business combination. Consideration is required of whether, and how readily, a third party could introduce those processes or acquire them from third parties by outsourcing or subcontracting. Consequently, it is possible that the acquisition will meet the definition of a business although, depending on the precise facts and circumstances, it might instead be considered to be the acquisition of an asset.

Example 6 : Acquisition of a mining tenement adjoining a producing mine

Company A has a long established mine, with an established processing facility and a rail head.

Company B owns the mineral rights adjacent to Company A's mine.

Company B has undertaken limited geological work, but all indications to date are that the area is a continuation of the same geological outcrop that Company A is mining.

Company B's work has not identified any proven and probable reserve in the area that it owns.

Company A acquires 100% of the share capital of Company B.

Company A acquires:

- Inputs: Mineral rights (not proven and probable) and geological data (limited)
- Processes: None
- Outputs: None.

Analysis

The absence of proven and probable reserves fails to satisfy the existence of the required input, and there are no processes.

This leads to a presumption that Company A has purchased an asset.

5. EXISTENCE OF GOODWILL

Goodwill arises from an excess of consideration payable by an acquirer that cannot be attributed to the identifiable net assets acquired. The existence of goodwill is strong evidence that the acquisition is a business combination under IFRS 3 *Business Combinations*. IFRS 3.B12 notes that:

> *'In the absence of evidence to the contrary, a particular set of assets and activities in which goodwill is present shall be presumed to be a business. However, a business need not have goodwill.'*

BDO comment

Goodwill typically arises from the existence of an in place work force and/or from synergies that the acquirer hopes to achieve from the acquired entity. Therefore the application of IFRS 3.B12 leads to a general presumption that a transaction involving the acquisition of a set of assets and liabilities that also includes a large or skilled workforce is a strong indicator that the transaction is a business combination.

As noted in section 3 above, in the case of acquisitions from entities that have a business model of acquiring rights, carrying out exploration and evaluation (E&E) activities and deriving the added value through sale (with no intention of carrying out development work themselves), it is necessary to consider whether the acquirer could operate the activities as a business. This may be evidenced by the acquisition involving a skilled exploration team as well as the mining rights and results from E&E activities to date, as a price premium might have been paid for that team. However, careful consideration would be needed of the contractual terms, in particular to determine whether the skilled team was attached to the mining rights and results from E&E activities, or whether the transaction was made up of two components (the acquisition of the rights, which gives rise to amounts recorded on balance sheet, and the signing of new employees, the costs of which are expensed). This will particularly be the case if consideration payable is contingent on work to be carried out in future by the new employees. The analysis would include consideration of the stage to which the E&E activities had progressed (that is, are there proven and probable reserves?).

5.1. Acquisition involving no workforce

In some cases, acquisitions do not include a workforce, or only a few individuals are 'acquired' with the business. Depending on whether the acquirer could supply the missing workforce element, this does not preclude the acquisition being classified as a business combination.

BDO comment

IFRS 3.B12 states that the presence of goodwill is not essential for an acquisition, and so it is not necessary for an acquisition to involve an in-place workforce to be classified as a business. This can give rise to classification issues where large items of infrastructure are acquired which are capable of generating outputs. In the mining sector this may include the acquisition of pipelines conveyors, railway infrastructure and haulage roads.

6. EXAMPLES OF WHETHER AN ACQUISITION GIVES RISE TO A BUSINESS COMBINATION

The principles set out in IFRS 3 *Business Combinations* (IFRS 3.B7-12) are illustrated in the following examples:

Acquisition	Inputs	Processes	Outputs	Conclusion
Scenario 1 – **Unlisted entity holding a single tenement, in the exploration and evaluation (E&E) phase** – **No employees and at least 2 years from a bankable feasibility study.**	Entity is in E&E phase with no employees, no inputs.	Entity has an exploration schedule but no processes in place to extract the mineral resource.	No planned development or production. (Entity is at least 2 years away from bankable feasibility study).	Most likely to be an **asset acquisition**.
Scenario 2 – **Listed entity holding 4 tenements. One tenement is indicating very promising drilling results** – **No bankable feasibility study has been prepared and there is no intent to enter development phase** – **Company employs geologists and a small administration team.**	Employees – although their skill base is very much on evaluation of mineral deposits and are not mining specialists.	Exploration and evaluation processes.	No output in terms of production, as the entity has not yet entered the development phase for any of its properties. Potential to argue that an active E&E program is an output in terms of allowing farm outs or disposals.	**Judgement required.** Most likely to be an **asset acquisition**.
Scenario 3 – **Listed entity holding 4 tenements** – **No tenements showing particular promise** – **Entity is undertaking minimal exploration** – **There is no bankable feasibility study or intent to enter development phase** – **Company has no employees.**	No employees.	No processes.	No development plans.	Most likely to be an **asset acquisition**.

Acquisition	Inputs	Processes	Outputs	Conclusion
Scenario 4 – **Listed entity holding 4 tenements** – **Company has an active exploration program** – **Company employs geologists and small administration team** – **Company's business model is to dispose of or farm out promising E&E activity rather than going into development or production.**	Employees and a portfolio of E&E properties.	Exploration program.	'Marketable' E&E property with drill results.	**Judgement required.** May be a business combination, depending on the stage of E&E activities (are there proven and probable reserves?).
Scenario 5 – **Listed entity holding passive interests in 4 tenements in the E&E phase** – **Each interest is the right to less than 10% of the mineral asset** – **The company does not actively participate in the exploration of these properties** – **Each property is being actively evaluated** – **Company does not employ geologists.**	Portfolio of E&E properties.	None, all processes rest with operators of the E&E projects.	None in respect of production revenues.	**Judgement required.** The listed entity's business may be to acquire interests in E&E phase activities, with the intention of generating income and profits from the future sale of those activities.
Scenario 6 – **Listed Company, holds one mineral licence, and is in the development phase** – **It has a bankable feasibility study (BFS), a work force working on developing the resource and administration staff.**	Mineral reserves, bankable feasibility study and skilled workforce.	Processes in respect of mineral production.	Future revenues from exploitation of mineral resource.	Likely to be a **business**.

Acquisition	Inputs	Processes	Outputs	Conclusion
Scenario 7 – **Listed entity holding passive interests in 4 tenements in the development phase** – **Each interest is less than 10% and company does not actively participate in the development of these properties** – **Company does not employ geologists or administration staff.**	Rights to mineral reserves.	None, all processes rest with operators of the development projects.	Future revenues from exploitation of mineral resource.	**Judgement required.** The listed entity's business may be to acquire interests in development phase activities, with the intention of generating income and profits from the future sale of both the product mined, and from the future sale of those activities.
Scenario 8 – **A producing mine sold by a large multinational miner** – **Purchase involves hiring of the existing workforce at the mine.**	Mineral reserves and employees.	Processes in respect of mineral production.	Revenue from production.	Meets the definition of a **business** even though acquisition does not involve acquisition of an incorporated entity or the purchase of shares.
Scenario 9 – **50% share in a producing mine, sold by a large multinational miner** – **Operational management of the asset will remain with the vendor** – **Vendor and purchaser enter into an arrangement that involves joint control.**	No employees. Rights to mineral reserves.	None.	Revenue from production.	Arrangement is subject to joint control and is therefore outside the scope of IFRS 3. Instead the arrangement is accounted for in accordance with IFRS 11 *Joint Arrangements*. (as the arrangement is not set up in a separate vehicle, it is classified as a 'joint operation').

Acquisition	Inputs	Processes	Outputs	Conclusion
Scenario 10 – **Listed entity holding passive interests in 4 tenements in the development phase** – **Each interest is operated through an arrangement that involves joint control and the listed entity does not actively participate in the development of these properties** – **The listed entity does not employ geologists or administration staff.**	No employees. Rights to mineral reserves.	None.	Revenue from production.	Arrangement is subject to joint control and is therefore outside the scope of IFRS 3. The acquirer's accounting will depend on: – Whether it is party to the joint control arrangement or is a passive investor, and – The structure of the arrangements.

Figure 2: Scenario analysis: Business or asset acquisition or other?

7. REVERSE ACQUISITIONS (OR 'BACKDOOR LISTINGS')

A common issue in the extractives sector is when a junior explorer obtains a listing by 'backing' into a listed shell company. The listed shell company typically has no business, no assets other than perhaps a cash balance and no employees. The transaction is usually structured as a share for share exchange, whereby the listed shell company issues shares to (in legal form) acquire the junior explorer.

Example 7 : Reverse acquisition by a junior explorer

Listed Shell Limited has 1,000 shares in issue.

It has a cash balance of CU100, has disposed of its previously held business and has not employees other than two Board members (whose sole task is to dispose of the company).

It issues 19,000 shares to acquire 100% of the share capital of Junior Limited an unlisted junior explorer.

Prima facie this transaction would appear to be a reverse acquisition within the scope of IFRS 3 *Business Combinations*, in which Junior Limited has acquired Listed Shell Limited. However, for this transaction to be within the scope of IFRS 3, Listed Shell Limited must meet the definition of a business.

In this example, Listed Shell Limited has disposed of its previously held business and has no operational employees. Its only asset is CU100 cash. Its current board will also resign once the transaction is completed.

Junior Limited acquires:

- Inputs: None
- Processes: None
- Outputs: None.

Analysis

Listed Shell Limited **does not** meet the definition of a business, and therefore this transaction is not within the scope of IFRS 3.

The transaction is instead that Junior Ltd has given up 5% of its own business (1,000/20,000 shares) to achieve a listing. This is a share-based payment within the scope of IFRS 2 *Share-based Payment*. The financial statements should be presented as a continuation of Junior Limited.

This accounting was confirmed by the IFRS Interpretation Committee as published in the March 2013 IFRIC Update. An extract from the March 2013 IFRIC Update is set out below:

> *'If the listed non-operating entity qualifies as a business on the basis of the guidance in paragraph B7 of IFRS 3, IFRS 3 would be applicable to the transaction. However, if the listed non-operating entity is not a business, the transaction is not a business combinations and is therefore not within the scope of IFRS 3. … it is therefore a share-based payment transaction which should be accounted for in accordance with IFRS 2. … any difference in the fair value of the shares deemed to have been issued by the accounting acquirer and the fair value of the accounting acquiree's identifiable net assets … should be considered to be payment for a service of a stock exchange listing for its shares, and that no amount should be considered a cost of raising capital. …the cost of the service received is recognised as an expense.'*

8. IASB STAFF PAPER: IFRS 3 – DEFINITION OF A BUSINESS – SUMMARY OF OUTREACH RESULT AND ANALYSIS

In May 2013, in order to contribute to the International Accounting Standards Board's (IASB's) post implementation review (PIR) of IFRS 3 *Business Combinations*, the IASB staff prepared a paper for discussion at a public meeting of the IFRS Interpretations Committee (the Interpretations Committee). The staff paper was prepared as a result of the Interpretations Committee wishing to share experiences of difficulties encountered in distinguishing a business combination from an asset acquisition.

The staff requested information from preparers of IFRS financial statements in the following industry sectors:

– Investment property
– Extractive industries
– Pharmaceutical
– Banking
– Solar and wind farms.

The staff paper can be found at:

http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/May/AP06A%20-%20WIP%20-%20Definition%20of%20a%20business%20-%20Summary%20of%20outreach%20results%20and%20analysis.pdf

8.1. Extractive industries sector

In its outreach the IASB staff asked the following general question:

'We are particularly interested in your experience of any difficulties in the identifying a business in an acquisition in the extractive industries. Specifically, what challenges do you face when distinguishing between an asset purchase and a business combination? What factors do you see as important when distinguishing a business combination from an asset purchase?'

The result of the outreach from the extractive sector shows that in the extractives sector there were two commonly applied views as to the application of IFRS 3.B7-B12 and the definition of a business. They are:

– **View 1**: Primarily based on the stage of the acquired project's life cycle and takes into account the intended output. This results in acquisitions of projects in the early stages of the exploration and evaluation phase being treated as asset acquisitions. It requires there to be a proven and probable reserve to be present in order for an acquisition to meet the definition of a business in IFRS 3.

– **View 2**: Adopts a wider view of outputs than View 1 and is not solely based on the business model of the acquirer. Instead it takes into account all types of market participants. This may result in earlier stage acquired projects being classified as a business. For example, an output might be viewed as being dividends from the sale of an E&E property. Proven and probable reserves are not required for an acquisition to meet the definition of a business in IFRS 3.

The staff paper reports that most respondents were in View 1. This approach distinguishes asset acquisitions from business combinations primarily based on the stage in its life cycle that the upstream oil and gas or mining operation is in at the time of the acquisition.

Acquisitions of upstream oil and gas or mining operations in the early stages of exploration and evaluation (E&E) are usually considered to be asset acquisitions, whereas acquisitions of upstream oil and gas and mining operations in the production phase are generally considered to be business combinations.

8.1.1. Technical analysis of IFRS 3.B7-B12 on the definition of a business by proponents of View 1

(i) Outputs

The intended output is determined on the basis of the business model of the acquirer. If the acquirer's business model is to sell the ultimate commodity, then the intended output is the commodity and not, for example, exploration data or the capital increase as a result of having ownership of the exploration data. Exploration data is only the intended output if the acquirer is only an E&E company.

(ii) Inputs

For an acquired set of activities and assets to be a business, one of the acquired inputs has to be a proven and probable reserve.

Proponents of View 1 argue that otherwise, the acquired set of activities and assets does not have the ability to create the output, that is, the ultimate commodity, when processes are applied to those inputs.

There was a variation in this approach for the mining sector, in that one of the acquired inputs has to be either a proven and probable reserve or mineralised material (that is, measured and indicated, not merely inferred).

Most respondents that were producers apply View 1 and rarely consider the acquisition of an upstream oil and gas or mining operation in the exploration or evaluation phase to be a business combination.

(iii) Processes

What types of processes give rise to a business? View 1 argues that only processes in the development, construction or production phase of an upstream oil and gas or mining operation can give rise to a business if the acquirer is a mining company. Only processes applied to the input (a proven and probable reserve) are able to create the intended output of such entities.

View 1 argues that processes associated with activities in the E&E phase do not give rise to a business. Even if the E&E processes were acquired together with a proven and probable reserve, proponents in View 1 would not classify the acquisition as a business combination, because they consider the E&E processes to be insignificant compared to the proven and probable reserve. View 1 therefore assumes that in substance, the purchase is only for the proven and probable reserve and nothing else.

Views varied widely among proponents of View 1 on when an upstream mining operation in the development and construction phase turns from an asset or a group of assets into a business.

8.1.2. Technical analysis of IFRS 3.B7-B12 on the definition of a business by proponents of View 2

The staff paper notes that some respondents take a broader view that is not based on the business model of the specific acquirer but considers all types of market participants.

(i) Outputs

Proponents of View 2 determine the output based on:

- The stage in the life cycle that the upstream mining operation is in at the time of the acquisition. If the operation is in the production stage, the output would be the produced commodity. If the operation is, however, still in the E&E stage, the output could be something such as dividends resulting from a sale of the E&E property and the related data or capital gains from selling the shares in the E&E operation, or
- The type of the licence. If the upstream mining operation is working with an exploration-only licence, the output could be something such as dividends resulting from a sale of the E&E property and the related data or capital gains from selling the shares in the E&E operation. If the upstream mining operation is instead working with an exploration and production licence the output could either be the ultimate commodity or something such as dividends resulting from a sale of the E&E property and the related data or capital gains from selling the shares in the E&E operation.

(ii) Inputs

Proponents of View 2 do not interpret IFRS 3 as requiring a proven and probable reserve as one of the inputs for an upstream oil and gas or mining operation to be a business. The factors that would influence the classification are based instead on whether the acquired inputs and processes are capable, on a stand-alone basis or through integration with other inputs and processes, of generating an output that will provide a return.

(iii) Processes

Under View 2, processes such as permitting activities, exploration and drilling programmes, or performing pre-feasibility/ feasibility studies, are processes that may give rise to a business, if they generate an output that will provide a return, either on a stand-alone basis or through integration with other inputs and processes.

8.1.3. Important factors to consider in distinguishing a business combination from an asset acquisition

The staff paper reports that practice has considered the following factors as important when distinguishing a business combination from an asset acquisition:

- Whether the acquired property is substantially undeveloped or developed with significant production
- Whether significant associated processes are included in the acquired operation, such as processing plants, pipeline infrastructure, and compressor stations
- Whether significant E&E costs have to be incurred after the acquisition to establish economic viability of the acquired property
- Whether significant development costs have to be incurred to bring the property into a producing status (such as costs for drilling activities, costs for linking production to transport facilities, costs for constructing compressor stations and drilling facilities)
- Whether staff and equipment have been acquired.

The staff paper also reports that a challenge arises in practice when multiple projects in different stages of development are acquired in one transaction and there is uncertainty over whether:

- The transaction should be bifurcated into asset acquisitions and business combinations, or
- The transaction should be classified according to the dominant part.

8.1.4. Conclusion

The application of IFRS 3.B7-B12 on the definition of a business is an area where significant judgement is required and in practice application is mixed.

For major producers acquiring mineral rights without proven and probable reserves in the E&E phase, it would appear that many preparers treat this as an asset acquisition.

However for acquisitions of mineral assets by exploration companies the IASB Staff paper notes that the analysis may be less clear. In particular, some question whether outputs can be regarded as being the sale of properties with enhanced geological data attached. If they can, then the focus would then be on the stage of development that the E&E geological data has reached. Consequently, when determining whether an acquisition by an exploration company constitutes a business, detailed analysis and careful judgement are required.

CONTACT

For further information about how BDO can assist you and your organisation, please get in touch with one of our key contacts listed below.

Alternatively, please visit **www.bdointernational.com/Services/Audit/IFRS/IFRS Country Leaders** where you can find full lists of regional and country contacts.

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