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# IFRS Viewpoint

## Acquisition of investment properties

### What's the issue?

When should a purchase of investment property (or properties) be accounted for as a business combination, and when as a simple asset purchase? This is an important issue because the IFRS accounting requirements for a business combination are very different from asset purchases.

Distinguishing business combinations and asset purchases can also be challenging for many other types of transaction and judgement is often required. This is particularly the case when investing in assets that generate cash flows on a standalone basis such as retail outlets and hotels. We focus here on investment property but the underlying arguments apply more broadly.

Our 'IFRS Viewpoint' series provides insights from our global IFRS team on applying IFRSs in challenging situations. Each edition will focus on an area where the Standards have proved difficult to apply or lack guidance.

**Relevant IFRS**

IFRS 3 Business Combinations

IAS 40 Investment Property

# Our view

## The purchase of investment property (or properties) is a business combination if the acquired set of assets and activities meets IFRS 3's definition of a business (IFRS 3 Appendix A and supporting guidance).

That guidance explains that a business consists of 'inputs' and 'processes' applied to those inputs that together have the ability to create 'outputs' (IFRS 3.B7). Determining whether a purchase of investment property is a business combination therefore requires a careful evaluation of the transaction and of what has been acquired (the 'acquired set'). This often requires judgement.

When purchasing an investment property the 'input' part of the definition is always met because the property itself is an input. If the property has in-place tenants and leases, the 'outputs' part is also met because rental is an output. Even with no in-place leases at the purchase date, a property that is substantially complete and available for letting may have the ability to earn rentals and therefore be capable of creating outputs. In these situations, deciding whether the acquired set is a business depends on whether any 'processes' are transferred and, if so, their nature and significance.

When an investment property has tenants, various services must also be provided, some of which may be specified in the leases. These and other services (or contracts for services outsourced to third parties) may be transferred to the buyer on purchase, in which case they are part of the acquired set. In our view, however, many basic services commonly associated with investment property are administrative functions that do not meet the definition of processes (IFRS 3.B7). Examples include: rent collection, basic tenant administration, basic maintenance, security and cleaning.

By contrast services that go beyond administrative matters are likely to be 'processes'. Processes typically involve specific knowledge or skills and can be significant to the decision to purchase the property(ies) and/or its value. The presence of processes in the acquired set is indicative of a business.

> "Determining whether a purchase of investment property is a business combination therefore requires a careful evaluation of the transaction and of what has been acquired."

However, the presence of a relatively unimportant process may not be enough – for example if other, more important processes are excluded.

Accordingly, in our view the transfer of some services does not necessarily mean that the acquired set is a business. As a general indication, our preferred view is that:

- the purchase of a property or properties with or without tenants in which no services are transferred should be accounted for as an **asset purchase**
- the purchase of a property or properties with tenants and with the transfer of only administrative-type services should also be accounted for as an **asset purchase**
- the purchase of a property or properties with tenants and more sophisticated services/activities should generally be accounted for as a **business combination** (in accordance with IFRS 3).

However, we also acknowledge that some commentators interpret IFRS 3's definition of a business in such a way that each of these scenarios could be a business combination. This is explained further below.

# More analysis

## Asset purchase versus business combination

It is important to distinguish business combinations from asset purchases because the IFRS requirements are very different. Some of the key differences are summarised in the table.

| Accounting topic | Business combination | Asset purchase |
|---|---|---|
| **Recognition of identifiable assets and liabilities** | • measured at fair value | • total cost is allocated to individual items based on relative fair values |
| **Goodwill or gain on bargain purchase** | • recognised as an asset (goodwill) or as income (gain on bargain purchase) | • not recognised |
| **Transaction costs** | • expensed when incurred | • typically capitalised |
| **Deferred tax on initial temporary differences** | • recognised as assets and liabilities | • not recognised unless specific circumstances apply |

## IFRS 3's definition of a business

IFRS 3 Appendix A defines a business combination as "a transaction or event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also business combinations". A business is then defined 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 B provides application guidance relating to the definition of a business. Paragraph B7 states that:

> "A business consists of inputs and processes applied to those inputs that have the ability to create outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business. The three elements of a business are defined as follows:
>
> a Input: 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.
>
> b Process: 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.)
>
> c Output: 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."

Further guidance is provided in IFRS 3.B7-B12.

## Recent developments

In December 2013 the IASB clarified the interaction between IFRS 3 and IAS 40. They added paragraph 14A to IAS 40 (as part of 'Annual Improvements 2011-13 Cycle') which clarifies that:

- judgement is needed to determine if an acquisition of investment property is the acquisition of an asset or a group of assets or a business combination within the scope of IFRS 3
- this judgement is made by reference to IFRS 3 (and not by reference to the discussion in IAS 40.7-14, which relates to whether property is owner-occupied property or investment property).

IAS 40.14A removes an argument that the generation of rental income, and activities such as property servicing and rent collection that are ancillary to earning rentals, can be disregarded when considering the definition of a business. Before the clarification some commentators argued that these features are implicit in the definition of investment property and, for that reason, should not be viewed as 'outputs' or 'processes'.

## Applying the revised guidance and definition to investment property

Despite this clarification applying the definition of a business to the purchase of an investment property remains challenging. This is particularly the case for purchases of property(ies) with in-place leases in which some services are transferred. For these purchases, the acquired set clearly includes 'inputs' and 'outputs'. The overall conclusion then depends on the assessment of the transferred services against the 'processes' component of IFRS 3's guidance. That assessment can be divided into two questions:

- are the transferred services 'processes'?
- if so, are the transferred processes sufficient to meet the definition of a business?

### Are the transferred services 'processes'?

IFRS 3's guidance explains that "Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs" (IFRS 3.B7). Accordingly, under our preferred view, it is also reasonable to conclude that the purchase of an investment property with in-place tenants and either no services or purely administrative functions is an asset purchase. In the context of investment property, examples of services that may be considered administrative functions include:

- rent collection and basic tenant administration
- basic maintenance
- security
- cleaning.

These services would usually be easy to replace. They are also unlikely to have a significant impact on the acquirer's investment decision or on its valuation.

By contrast, services that go beyond administrative matters are likely to be 'processes'. Processes typically involve specific knowledge or skills and can be significant to the investment decision and the valuation. In the context of investment property, 'processes' might include:

- marketing
- portfolio management (investment, divestments and associated activities)
- financial management
- more sophisticated property management services.

Assessing whether an acquired service is an administrative function or a process may require judgement.

### Are the transferred processes sufficient to meet the definition of a business?

In our view, the acquired set is not a business if no processes at all are transferred. In saying this we acknowledge IFRS 3.B8, which explains that: "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, for example, by integrating the business with their own inputs and processes." Based on this guidance, some commentators reason that an absence of processes does not necessarily mean that the acquired set is a purchase of assets. This Viewpoint does not apply that line of reasoning but it is important to be aware that divergent views exist.

Even if some processes have been transferred, the acquired set may not always be a business. The transfer of a relatively unimportant process may not be conclusive if other, more important processes necessary to generate returns have not been transferred.

Unfortunately, IFRS 3 does not expand on the number or type of processes that can be missing for an acquired set to be an asset purchase rather than a business combination. This has led to questions and divergent views.

### Additional factors to consider

Additional factors that indicate a business combination include:

- a purchase that includes separately identifiable assets and/or liabilities that would not ordinarily be considered as part of the property
- the purchase of an entity (or group of entities) that previously operated independently as a property business (in contrast for example to a subsidiary with a single investment property sold by one group to another)
- the purchaser's motivation for the acquisition goes beyond adding to its property portfolio
- the existence of goodwill in the acquired set (IFRS 3.B12).

## Considerations for investment property held in a separate legal entity

It is common in some jurisdictions for a single investment property to be held in a separate legal entity and for a purchaser to acquire that entity rather than the property. The acquisition of a legal entity does not necessarily mean the acquired set is a business. The assessment of the acquired set is based on the same analysis discussed above; however, the acquisition of a legal entity brings with it all of the entity's assets, liabilities, contractual agreements and obligations and therefore may trigger the need for additional questions and analysis.

### IFRS Interpretations Committee (IFRIC) research

Research undertaken in 2013 by the staff of the IFRIC has identified various challenges in applying the existing definition and some diversity in practice. This diversity mainly related to the types of acquired process considered necessary for an acquired 'set' to constitute a business. Two broad approaches were identified by IFRIC staff:

- one broad approach is that any processes that, when applied to an input or inputs, create or have the ability to create outputs, give rise to a business
- the other broad approach is to distinguish between relatively simple processes and more 'sophisticated' processes or processes that involve a degree of knowledge unique to the assets that would need to be acquired for the acquired set to constitute a business.

The guidance in this publication follows the second broad approach. In our experience, this approach is more common in most jurisdictions that apply IFRS.

# Examples

## Scenario 1 – single property, no tenants or services

ShellCo holds a single investment property. The property is complete but has no tenants. ShellCo has no staff and does not undertake any services.

**Analysis**

In our view this is an asset purchase. ShellCo has no tenants or in-place leases (ie it does not generate outputs) and no services are transferred to PropCo.

## Scenario 2 – single property with tenants

ShellCo holds a single investment property. The property has in-place tenants and leases but no support services or contracts are transferred when ShellCo is acquired.

**Analysis**

In our view this is also an asset purchase. ShellCo is revenue-generating, but no processes have been transferred to PropCo. Although the rental agreements are likely to contain servicing obligations, PropCo has not acquired any actual activities.

We do however acknowledge an alternative view that the property could meet the definition of a business if market participants are capable of generating a return from the acquired 'set' by integrating it with their own inputs and processes (IFRS 3.B8). However, although Scenario 2 is less clear-cut than Scenario 1, in our experience predominant practice in most jurisdictions is to classify the purchase as an asset purchase when the acquired set does not include any processes.

## Scenario 3 – single property with tenants and simple services

ShellCo holds a single investment property. The investment property has tenants subject to rental agreements. Certain outsourced contracts for maintenance and security services are also transferred. PropCo intends to allow these contracts to run to expiry and will then replace them with its own in-house services.

**Analysis**

Our preferred view is that this is also an asset purchase. In this case support services have been transferred, even though they will be performed by external providers. However, these services are relatively simple, administrative-type services. The service contracts are unlikely to be a significant factor in PropCo's investment decision or valuation. In accordance with the guidance provided, such services are not considered to be processes that are used to create outputs.

As for Scenario 2 it is also possible to argue that the acquired set is a business, on the basis of:

- taking a different view of the significance of the acquired services in the context of the transaction and the definition of a business; and/or
- the ability of market participants to generate a return from the acquired 'set' by integrating it with their own inputs and processes (IFRS 3.B8).

## Scenario 4 – multiple properties, tenants, services and staff

ShellCo holds eight investment properties. The investment properties have tenants subject to rental agreements. B also employs several staff dedicated to the properties' management, the provision of services included in the rental agreements, and administration such as invoicing, cash collection and management reporting.

The transferred staff also include managers responsible for portfolio management, raising finance and marketing.

**Analysis**

In our view this is a business combination. PropCo has acquired a group of revenue-generating assets along with various staff and activities that clearly go beyond activities ancillary to the properties and their tenancy agreements.

## Future developments

At the time of writing the IASB is undertaking a project to review IFRS 3's definition of a business and supporting guidance. They intend to clarify how how a company determines whether it has acquired a business or a group of assets. They are aiming to amend the Standard in the second half of 2018.



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