

# Practical guide to IFRS

## Business combinations: determining what a business is under IFRS 3 (2008)

### Introduction

Application of the revised business combinations standard, IFRS 3 (2008), has revealed a number of implementation challenges. One of the most significant is the determination of what a business is under the revised standard. The definition of a business was only changed to include the three words: 'is capable of'. However, the inclusion of expanded application guidance, changes to the scope of the standard and convergence with US GAAP has led to more transactions being seen as business combinations compared to the conclusions reached under the previous standard.

Any transaction in which an entity obtains control of one or more businesses

qualifies as a business combination and is subject to the measurement and recognition requirements of IFRS 3 (2008). Differentiating between a business or a group of assets under IFRS 3 (2008) can be challenging. If the group of assets is not a business, the different accounting can have a substantial impact on the financial statements.

Some of the key differences between a business combination and an asset acquisition are the requirements to record the full fair value of all assets, liabilities and contingent liabilities, recognition of goodwill, the treatment of transaction costs, the requirements for contingent consideration and the deferred tax consequences.

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#### Introduction

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Area	Business combination	Asset or group of assets
Measurement of assets and liabilities	Recorded at fair value	Recorded at cost; cost is allocated over the group of assets based on relative fair value
Transaction costs	Expense as incurred	Capitalised as part of the cost
Contingent liabilities	Recognised if represents present obligation that arises from past events and its fair value can be measured reliably with subsequent changes to profit or loss	Not recognised; subject to IAS 37
Goodwill	May be recognised	Not recognised
Deferred taxes	Deferred tax assets and liabilities, related to any temporary differences, tax carry-forwards and uncertain tax positions are recorded	Initial recognition exemption applies; deferred tax assets and liabilities for temporary differences are not recognised

A business is defined in IFRS 3 (2008) 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'*.

What does this mean in practical terms? Most transactions will be obvious business combinations (for example, the acquisition of a major multinational business) or asset transactions (for example, the purchase of a single piece of earth moving equipment). However, the assessment can become complex and judgmental. An acquired group of assets is considered to be a business if it includes inputs and processes applied to those inputs that have the ability to create the outputs of a business.

#### **Example 1: Acquisition of a business**

**Facts:** Phone Company A acquires 100% of the shares of a Phone Company B.

**Analysis:** the elements in the acquisition contain inputs, processes and outputs.

**The inputs are:** land, buildings, infrastructure (for example, call centres, cell tower leases, switches, software, licences and retail stores), furniture, computer software, customer and supplier relationships, reputation, customer contracts, brand, market share, market knowledge, experienced work staff and management expertise.

**The processes are:** management processes, corporate governance, organisational structures, strategic goal-setting, operational processes and human and financial resource management.

**The outputs are:** revenue from customers, access to new markets, increased efficiency, synergies, customer satisfaction and reputation.

A business has been acquired because all the assets and activities to provide a return are included.

Outputs, specifically revenue or saleable products or services, are not required for a group of assets to qualify as a business. A business also does not need to include all of the inputs or processes the seller used in operating that business if a market participant would be capable of acquiring the business and continuing to produce outputs. Processes are separate from the people required to apply those processes. A business will need people, but they do not have to be the current individuals carrying out those processes. A market participant could, for example, integrate the business with its own inputs and processes or easily acquire any missing inputs or processes. Inputs, processes and outputs will vary by industry, by structure and by stage of the business, adding another layer of complexity to the assessment.

Not all processes need to be acquired, but the standard is silent as to whether this means at least one process or whether it is possible to acquire no processes yet still meet the definition of a business. Significant judgement is required if no processes are acquired; compelling evidence should be presented (for example, a market participant either would already have those processes or could easily replicate the current processes over a relatively short time period).

#### **Example 2: Acquired assets and operations without outputs**

**Facts:** Computer Company A acquires Software Development Company B. Company B has been formed to make hand-held device applications. The current activities of the company include researching and developing its first product and creating a market for the product. The company has not generated any revenues and has no existing customers. Company B's workforce is composed primarily of programmers. Company B has the intellectual property, software and fixed assets required to develop applications.

**Analysis:** the elements in the acquisition contain both inputs and processes.

*The inputs are:* intellectual property used to design the applications, fixed assets and employees.

*The processes are:* strategic and operational processes for developing the applications

It's likely that a business has been acquired because Company B has access to the inputs and processes necessary to manage and produce outputs. The lack of outputs, such as revenue and a product, does not prevent the company from being considered a business.

The determination of what a business is has emerged as one of the key challenges in applying IFRS 3 (2008). There is no bright line as to what the key inputs are and processes that a market participant could not supply on their own, and how many key inputs and processes must be included in the transaction to be a business. This 'practical guide' includes a framework to assess whether a business has been acquired in situations where judgement is required. We look at some industry-specific examples of what inputs and processes could be considered indicators for meeting the definition of a business and some of the factors to be considered.

This guide is not intended to create a subset of additional rules but will hopefully help in applying the standards. Management should always consider the full text of the standards, consult with their auditors and apply professional judgement to their specific accounting questions.

Assessing if control exists is the next step if an entity determines it has acquired a business. A business combination has not occurred unless the entity obtains control of the business. An entity may have acquired the right to participate in a business, but not control. The analysis of control is based on a number of factors including equity shareholding, control of the board, potential voting rights and other contractual arrangements.

## 1. Determination framework

A business is 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*'.

The three components of a business are:

- **Input:** an economic resource that creates, or has the ability to create, an output when one or more processes are applied to it. Examples include long-lived assets (including intangible assets and rights to use long-lived assets), intellectual property, the ability to obtain access to necessary materials or rights, and employees.
- **Process:** a system, standard, protocol, convention or rule that creates, or has the ability to create, outputs when applied to an input or inputs. Examples include strategic management processes, operational processes and resource management processes. These processes are typically documented; however, an organised workforce with the necessary skills and experience and that follows rules and conventions may provide the processes that are capable of being applied to inputs to create outputs. Accounting, billing, payroll and other administrative systems are not typically processes used to create outputs.
- **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.

A business consists of inputs and processes applied to the inputs that have the ability to create outputs. Not all of the inputs and processes need to be transferred to a business, as long as a market participant is able to continue to conduct the business to provide a return.

## **Excerpts from the standards – the definition of a business**

### **Definition of a business in IFRS 3.87 (2004):**

An integrated set of activities and assets conducted and managed for the purpose of providing a return to investors or lower costs or other economic benefits directly and proportionately to policyholders or participants.

A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate revenues. If goodwill is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business.

### **Definition of a Business and Application Guidance in IFRS 3.B7-B12 (2008):**

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.

To be capable of being conducted and managed for the purposes defined, 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, for example, by integrating the business with their own inputs and processes.

The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities.

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.

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.

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.

Although businesses usually have outputs, these are not required for an integrated set of activities and assets to qualify as a business. The existence of goodwill in the acquired group creates a presumption that it is a business.

In situations where uncertainty exists as to whether a transaction is the acquisition of a business or assets, the following framework

may be helpful in making this decision:

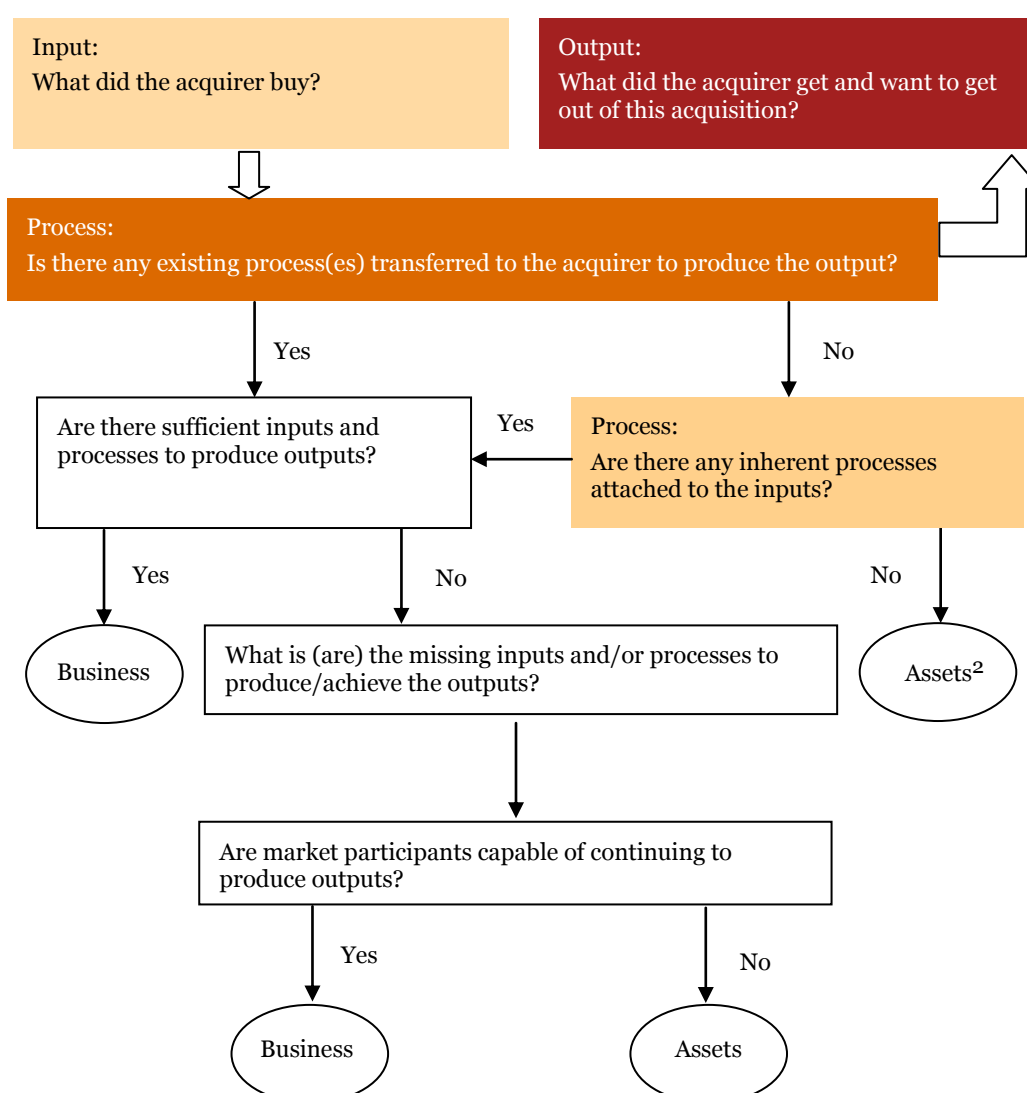
- Identify the elements in the acquired group;
- Assess the capability of the acquired group to produce outputs; and
- Assess the capability of a market participant to produce outputs if missing elements exist.

The flow chart below attempts to combine the components defined under IFRS 3 (2008) with the decision-making framework.

### *Determination framework*

#### **Framework<sup>1</sup>**

**Step 1:**  
Identify elements in the acquired group



**Step 2:**  
Assess capability of the group to produce outputs

**Step 3:**  
Market participant's ability to produce outputs

<sup>1</sup> Consideration significantly in excess of the fair value of assets acquired is a strong indicator of goodwill and therefore a business.

<sup>2</sup> The acquired group may still be a business if a market participant could easily replicate the missing processes in a relatively short time period. This determination requires judgement, and entities need to consider the relevant facts and circumstances.



### ***Step 1: Identify the elements of the acquired group***

The starting point for the analysis is to understand the inputs, processes and potential outputs. It can be useful to consider existing processes, physical assets, inputs used in the past and processes of similar businesses. Another approach is to consider the inputs and outputs together in order to identify associated processes that would be necessary to create the outputs. For example, what processes does an automotive entity perform to sheet metal and acquired parts in order to produce a car? Outputs are not required for a business to exist. For example, a start-up company with no products, revenue or customers can be a business. The results of research and development could provide return to investors.

### ***Step 2: Assess the capability of the group to produce outputs***

The acquirer needs to consider if the inputs acquired and processes transferred can produce outputs. There may be inherent processes attached to inputs. If a workforce is transferred, for example, it is reasonable to assume that the workforce has processes to produce the output. These types of inherent processes need to be considered.

### ***Step 3: Assess the capability of a market participant to produce outputs if missing elements exist***

Missing elements do not automatically mean that a group of assets and liabilities is not a business. A market participant may be capable of supplying the missing elements and producing outputs. The missing elements could be replaced through integrating the acquired group into an entity's own operations. Market participants are theoretical third parties that could either be trade buyers or financial investors and are knowledgeable willing parties. The acquirer does not need to be a market participant in the same industry. The analysis of supplying the missing

elements to produce outputs should have the same result whether the acquirer is a financial investor or a trade buyer. The question of whether missing elements can be replicated or obtained by market participants is not buyer-specific. For example, if a financial investor acquires a hotel, it may not have processes in place to run it. The financial investor could acquire relevant processes from a market participant such as another hotel management group. The easier it is to obtain the missing elements in a relatively short time-period, the more likely the set of assets and activities are a business. This determination requires judgement; entities need to consider the relevant facts and circumstances, including the nature and stage of the business and the transaction structure.

## ***2. Practical examples***

### ***2.1 Mining industry***

#### ***Facts***

A multinational energy and mining entity has acquired a small coal exploration company, Coal Exploration Company X. Company X has a sizeable portfolio of properties with potential coal reserves in a basin where other coal mining companies have recently discovered large proven coal reserves. Company X has an active exploration programme in place at all its properties, but none of them are yet in development. Studies have been conducted on the properties, and the results are included in the transaction. Several of the key management team of Company X were involved in previous successful exploration, development and production projects, and they will transfer into the group. Company X does not own equipment to extract the reserves but has acquired licences and equipment for the development of the properties. Company X's office building was included in the transaction. Company X had an engineer and geologist team, accounting staff and payroll clerk, but these employees will not continue in employment after the acquisition.

## **Analysis**

### **Step 1: Identify the elements of the acquired group**

The inputs acquired include:

- **Tangible items:** an office building and equipment necessary for exploration of the potential coal reserve properties;
- **Intangible items:** exploration and production licences for a number of potential coal mining properties, computer software, software licences; and
- **Other items not necessarily in the financial statements:** a management team, the process and know-how of coal exploration, studies and test results of the properties, market knowledge, relationships with the licensing body, management knowledge of the industry.

The processes acquired include: management team processes, expertise and industry knowledge.

The outputs acquired include: access to the exploration results, access to potential coal reserves and access to management's strategic plans.

### **Step 2: Assess the capability of the group to produce outputs**

Production has not begun, but there is an active exploration programme at the portfolio of properties. The exploration results could be viewed as the output. Some of the inputs and processes necessary to produce the exploration results appear to have been acquired. There may be inherent processes attached to the inputs because exploration equipment, software and a skilled management team are being transferred. The management team may possess the know-how to provide a return from the exploration studies. The missing inputs include the engineer and geologist team, accounting staff and payroll clerk. The accounting staff and payroll clerk could be considered administrative and would not impact the conclusion. The absence of the geologist and engineer team might be more fundamental.

### **Step 3: Assess the capability of a market participant to produce outputs if missing elements exist**

Management needs to consider whether market participants could produce exploration results with the established inputs and processes. The buyer may determine that market participants would be strategic buyers that have an existing engineer and geologist team. The missing engineer and geologist team might not alone preclude the acquired group from being a business. It is irrelevant whether the buyer has an existing engineer and geologist team. The buyer must evaluate whether the engineer and geologist team can easily be replicated by a market participant. This will require judgement and will be based on the facts and circumstances in each situation. A business may have been acquired if the buyer determines the engineer and geologist team can be replicated. A group of assets may have been acquired if the buyer determines that a market participant could not assemble an engineer and geologist team. It is unlikely that the buyer would wish to acquire these types of assets without either keeping key people or being able to find their equivalents in the market.

## **Conclusion**

Company X is considered to be a business. The missing engineer and geologist team could easily be replicated by a market participant in a relatively short time-period. The acquired input of the management team is accompanied by inherent processes.

## **2.2 Hotel industry**

### **Facts**

A multinational hotel group enters into an agreement with a local hotel group in Country A. The local hotel group operates 80 hotels in Country A and wishes to refocus its operations to concentrate on 30 key hotels. The multinational hotel group enters into a master agreement with the local hotel group to take over existing leases for 50 non-core hotels. Customer lists associated with these

hotels, fixtures and fittings at each property as well as the staff employed at each hotel will also be transferred to the multinational hotel group. The multinational group will be entitled to all revenue arising on any bookings existing at the agreement date. The multinational group will rebrand the hotels subsequent to this transfer and will also transfer all hotels to its own IT system.

## **Analysis**

### **Step 1: Identify the elements of the acquired group**

The inputs acquired include:

- **Tangible items:** fixtures and fittings at each hotel;
- **Intangible items:** leases for each property, customer lists; and
- **Other items not necessarily in the financial statements:** staff employed at each hotel.

The processes acquired include: relevant management and operational processes as a result of acquiring staff required to operate each hotel.

The outputs acquired include: access to economic benefits arising from current and future bookings.

### **Step 2: Assess the capability of the group to produce outputs**

The acquired group is not contained within a corporate entity 'wrapper'. The multinational group has effectively acquired 50 hotel leases accompanied by fixtures and fittings, customer lists, an existing order book and relevant staff. The items included in the acquired group are capable of producing revenue. The key elements that enable the acquired group of properties to produce outputs are the internal structure of each property as a hotel with the appropriate fixtures and fittings (as opposed to properties structured for alternative use), the acquisition of customer lists and the relevant staff and processes.

### **Step 3: Assess the capability of a market participant to produce outputs if missing elements exist**

There are few missing elements in this case before a market participant could produce outputs. The multinational group intends to rebrand and replace specific processes to align these hotels with the rest of its portfolio. The acquired properties have the current ability to produce outputs without these changes.

## **Conclusion**

The acquired group of hotels is considered to be a business.

If the multinational hotel group had acquired 50 empty properties not configured as hotels and missing fixtures and fittings, customer lists or staff, the acquired group might be considered an asset acquisition. If the properties were configured as hotels with the relevant fixtures and fittings but the staff of the hotels was not acquired, judgement would be required in determining a market participant's capability to obtain the missing elements in a relatively short time-period. The missing elements would primarily be staff, and the associated management and operational processes. The relevant facts and circumstances would need to be considered to determine whether appropriately skilled labour is readily available in the market.

## **2.3 Port industry**

### **Facts**

An international shipping entity purchased a storage and warehouse facility at an Asian port. The warehouse earned rental on storage units and associated service fees by using its existing assets and labour workforce prior to the acquisition. The warehouse has not been profitable for three years. The shipping entity believes that this is due to inefficiencies from outdated computer software that automates the handling of the supply and delivery of the goods. The shipping entity hired specialist software companies to



investigate and develop replacement software as part of the transaction. The shipping entity acquired all other assets excluding the existing software. It kept the management team and labour workforce for their experience and relationship with the local port authorities. It did not retain any customers, as the warehouse will only be used by the acquirer to offer extended services to its own customers. The purchased storage and warehouse facility is expected to generate cost savings, as the entity will not need to use third-party storage facilities.

### **Analysis**

#### **Step 1: Identify the elements of the acquired group**

The inputs acquired include:

- **Tangible items:** storage infrastructure, loading machineries, office equipment;
- **Intangible items:** land use rights, current supplier relationships; and
- **Other items not necessarily in the financial statements:** labour force, management team.

The processes acquired include: expertise and industry knowledge, other operational processes such as warehouse management process, supplier's management processes.

The outputs acquired include: expanded services offered and cost savings through vertical integration.

#### **Step 2: Assess the capability of the group to produce outputs**

The acquirer's intention and future plans for the assets or business acquired are not considered. The key assessment is to determine if the warehouse is able to produce outputs without the key missing elements, such as customer contracts and the warehouse software system. The missing inputs, such as customers, would not impact the group's ability to produce outputs, so it would not impact the

conclusion. The absence of the warehouse computer software management system might be more fundamental because it automates a key process of the facility.

#### **Step 3: Assess the capability of a market participant to produce outputs if missing elements exist**

Even though the warehouse was operating with outdated software, it was using the software to generate revenue. The shipping entity must evaluate whether the outdated software is a significant input. This includes evaluating whether the processes organised by the software can be easily replicated by a market participant. This requires judgement and will be based on the facts and circumstances in each situation.

The owner of the warehouse was keen to sell its assets to the shipping company and granted full access to a software specialist firm hired by the acquirer. The new software has been developed and is ready to be installed immediately after acquisition. It can be argued that the missing element of computer software is easily replicated on the market within a short time-period.

### **Conclusion**

The acquired warehouse facility is considered to be a business.

The missing processes generated by the software could easily be replicated by a market participant in a relatively short time-period. A group of assets may have been acquired if the facility was not operational without the software. This would be unlikely because the software is not complex. A market participant could also replicate existing software functions by running the warehouse manually. The software is considered fundamental to the business, but the management team and labour workforce could produce outputs without software or with new software.

## 2.4 Port industry

### Facts

An existing port operating entity ('the operator') acquired the right of operation for an existing terminal from the local port authority. The local port authority also owns other terminals at this location. This transaction is structured as a carve-out where legally certain assets are transferred to the operator. The port is a cargo container port but also includes supporting paperwork-handling and storage facilities. No employees or customers are included in this transaction. All existing employees will be redeployed by the local port authority. All existing customers will continue to be serviced by the local port authority from other terminals. The operator plans to improve the terminal by installing more advanced computer systems to replace the systems retained by the local port authority, increasing the number of gantry cranes and upgrading the lifting equipment.

### Analysis

#### Step 1: Identify the elements of the acquired group

The inputs acquired include:

- **Tangible items:** port infrastructure such as berths, cranes and roads connecting the terminal to the warehouse, an office, storage facilities;
- **Intangible items:** land use rights, operating rights; and
- **Other items not necessarily in the financial statements:** location.

The processes acquired include: none.

The outputs acquired include: expanded service offering.

#### Step 2: Assess the capability of the group to produce outputs

The acquirer's intention and future plans for the assets or business acquired are not considered. The assessment is to determine if the operator is able to produce outputs without the missing elements including employees, customers, software and all processes. The missing customers and employees could be significant for the group's ability to produce outputs for a port operation.

#### Step 3: Assess the capability of a market participant to produce outputs if missing elements exist

The operator must evaluate if the facilities could be operational and whether missing elements could easily be replicated by a market participant in a relatively short time-period. This requires judgement and will be based on the facts and circumstances in each situation. For example, when the inputs (berth, warehouse and existing cranes) are present without processes, how difficult will it be for the operator to hire new employees, find customers and implement procedures for port-related services? The missing inputs and required processes in this example may be sufficiently significant to conclude that the property acquired is a group of assets.

### Conclusion

The acquired warehouse facility is considered to be an asset acquisition.

No processes were acquired. The acquisition did not include employees or existing customers. The missing employees, customer contracts and processes are significant in generating output. There is no compelling evidence that missing elements could be easily be replicated by a market participant in a relatively short time-period.

## 2.5 Real estate industry

### Facts

A real estate investment entity, Properties Inc, has acquired an empty building during the year. The building has no tenants upon acquisition. The building contains no furniture. Properties Inc will undertake the day-to-day property management. No existing employees were hired by Properties Inc.

### Analysis

#### Step 1: Identify the elements of the acquired group

The inputs acquired include:

- *Tangible items*: the building
- *Intangible items*: none
- *Other items not necessarily in the financial statements*: none.

No processes have been acquired.

The outputs acquired include: none

#### Step 2: Assess the capability of the group to produce outputs

Processes that allow the Properties Inc to find tenants, run the day-to-day operations and strategically position the property in order secure future tenants are missing. These would include:

- marketing to new tenants;
- management of the property's leasing profile and tenant mix;
- management of capital expenditure on the property (for example, decisions to repair, renovate, redevelop and/or expand the commercial office tower); and
- management of the initial and continued funding of the property.

Properties Inc will not be able to produce outputs without these processes.

#### Step 3: Assess the capability of a market participant to produce outputs if missing elements exist

Properties Inc is an owner and manager of real estate. No tenants or management of the building were acquired. The building will form part of its larger

portfolio going forward; Properties Inc's management will perform this role.

### Conclusion

The acquired building is considered an asset acquisition regardless of whether the missing process could be replicated through integration of the building into Properties Inc's existing business. No processes were acquired as part of the transaction. The missing processes cannot be easily replicated by a market participant in a relatively short time-period.

## 2.6 Real estate industry

### Facts

A real estate investment entity (REIE) is an owner and manager of commercial office towers across the east coast of Australia.

REIE's management has decided to expand and diversify its existing operations by purchasing a portfolio of commercial properties on Australia's west coast. REIE has no existing operations in this location and limited local market knowledge and experience. The acquired portfolio of commercial property has 85% occupancy on average, with leases being executed between the tenants and the freeholder of the property. REIE becomes a party to these lease agreements upon acquisition of the freehold title to the commercial properties.

Existing security, cleaning and maintenance contracts are novated to REIE upon acquisition of the property. The existing property management agreement will be terminated. REIE will undertake all property management functions: tenant management, collection of rent and supervision of contract work at the commercial properties.

REIE will employ a number of the vendor's employees, including the regional leasing managers and other management personnel. These employees will be responsible for:

- the property's leasing profile and tenant mix;

- capital expenditure on the property (for example, decisions to repair, renovate, redevelop and expand);
- additional investment and divestment decisions (for example, buy or sell additional properties); and
- other decisions concerning the strategic positioning of the west coast portfolio.

The acquisition price has been based on an independent valuation of the commercial properties individually, using discounted net cash flows, and taking into consideration rental returns less property outgoings, over a 10 year period.

### ***Analysis***

#### ***Step 1: Identify the elements of the acquired group***

The inputs acquired include:

- ***Tangible items***: the commercial office towers;
- ***Intangible items***: existing lease agreements with tenants, security, cleaning and maintenance contracts; and
- ***Other items not necessarily in the financial statements***: management team, management knowledge of the Australian market and portfolio.

The processes acquired include: management team processes, expertise and industry knowledge.

The outputs acquired include: the right to receive cash flows in the form of rental returns and potential capital growth in the property.

#### ***Step 2: Assess the capability of the group to produce outputs***

Processes in the strategic management of the commercial properties have been acquired by REIE. These processes will allow REIE to realise the value of the

commercial properties and generate outputs, through both rental returns and future growth in the valuation of the properties.

#### ***Step 3: Assess the capability of a market participant to produce outputs if missing elements exist***

Inputs and processes have been acquired by REIE that allow outputs to be generated.

No further analysis concerning the capability of a market participant to produce outputs is required.

### ***Conclusion***

The acquired portfolio is considered to be a business.

## ***2.7 Pharmaceutical industry***

### ***Facts***

Laboratory Inc is a pharmaceutical entity that owns the rights to several product (drug compound) candidates. Laboratory Inc's current activities include researching and developing the product candidates. Laboratory Inc does not have a manufacturing facility and has no revenues or commitments from customers if any of the product candidates become marketable. Laboratory Inc employs management and administrative personnel, as well as scientists who are instrumental to product testing and development, and have established protocols and procedures to carry out these functions. Pharmaceutical Inc is an established pharmaceutical entity with a large sales force. Pharmaceutical Inc acquires certain assets of Laboratory Inc, including the rights to the product candidates and related testing and development equipment. Pharmaceutical Inc hires the scientists formerly employed by Laboratory Inc.

## ***Analysis***

### ***Step 1: Identify the elements of the acquired group***

The inputs acquired include:

- ***Tangible items***: testing and development equipment;
- ***Intangible items***: rights to the product candidates and associated research and development; and
- ***Other items not necessarily in the financial statements***: scientists formerly employed by the seller.

The processes acquired include: procedures developed and applied by the scientists and operating protocols.

The fact that Laboratory Inc does not have revenues or commitments from customers does not preclude the existence of outputs. The outputs acquired could include access to potential marketable product candidates from the testing and development programme.

### ***Step 2: Assess the capability of the group to produce outputs***

There is an active research and development programme to develop marketable product candidates, even though acquired product candidates are not yet marketable at the acquisition date. The inputs and processes necessary to produce the testing and development

results appear to have been acquired. The acquisition of the rights to product candidates and operational protocols either represent processes or suggest that inherent processes may be attached to the inputs acquired. The missing inputs include manufacturing capabilities, management and sales personnel.

### ***Step 3: Assess the capability of a market participant to produce outputs if missing elements exist***

The lack of manufacturing capabilities, management and sales personnel may not prevent the acquired group from being a business. This is because Pharmaceutical Inc might determine that the likely market participants are strategic buyers in the pharmaceutical industry that either have the missing elements or could easily obtain them. A determination by Pharmaceutical Inc that Laboratory Inc is a development-stage enterprise would not preclude the acquired group from being a business.

## ***Conclusion***

The acquired group is considered to be a business. The acquired inputs (scientists and rights to product candidates) and processes (protocols) applied to those inputs have the ability to generate outputs (the results of the testing and development of product candidates) and collectively appear capable of providing a return to investors.