New Definition of Business in the Accounting Context

Mergers and Acquisitions are a way to keep growing a business while achieving instant results.

A company can secure an opportunity through a merger or acquisition allowing the business to enter new markets or offering new options to their existing markets. These transactions may take many forms, from acquisition or combination of target companies to acquisition of target assets. Interestingly, the accounting treatment of a merger or acquisition does not depend on the legal form, but whether the transaction falls into "business" as defined in the accounting context. As CLP also makes use of mergers and acquisitions to keep growing its business, we want to take this opportunity to introduce the new accounting definition of business and its application. Readers interested in the acquisition accounting under business combination can visit the Accounting Mini-series in our website where we have discussed this topic in detail in the past.

Why It Matters

The definition of business is used in determining whether a transaction should be accounted for as an asset acquisition or as a business combination. This distinction is important because the accounting for an asset acquisition significantly differs in certain respects from the accounting for a business combination. Business combinations require the assets acquired to be recognised at fair value with goodwill or gains from bargain purchase recognised. However, asset acquisitions allocate the purchase price to the assets acquired on a relative fair value basis among the assets and no goodwill or gain is recognised.

The application of the definition of business was a very complicated issue in the past, which also resulted in many transactions qualifying as business combinations. The new definition of business based on the HKFRS 3 (revised) does not change the accounting method for business combinations nor asset acquisitions. Instead, it provides a new and narrower definition of business, which will likely result in fewer acquired sets of assets to be identified as businesses.

Key Accounting Implications

Business Combinations		Asset Acquisitions
Fair valued	Identified assets (tangible and intangible) and liabilities	Purchase price allocated based on relative fair value
Expensed as incurred	Transaction costs	Capitalised as part of the purchase price
Recognised	Goodwill	Not recognised
Recognised (occur in occasion)	Bargain purchase	Not recognised
Recognised all resulting deferred tax liabilities and certain deferred tax assets	Deferred tax due to differences from original carrying amounts	Exempted to recognise

New Definition of Business

The new definition focuses on whether an input and a substantive process applied to the input together create outputs or have the ability to contribute to the creation of outputs. Despite most businesses having outputs, outputs are not necessary for an integrated set of assets and activities to qualify under the definition of business, such as early-stage companies that have not generated revenue.

Elements

Inputs

An economic resource that creates outputs, or has the ability to contribute to the creation of outputs

- Tangible fixed assets
- Right-of-use assets
- Intangible assets
- Intellectual property

Processes

A system that when applied to an input, creates or has an ability to contribute to the creation of outputs

Processes of:

- strategic management
- operation
- resource management

Outputs

The result of applying inputs and processes that provide goods or services to customers, generate investment income or other income from ordinary activities

- Revenue
- Dividend
- Interest income

Three Key Tests to Identify a Business

To determine if the acquired set of activities and assets is a business, three key tests were introduced under the new business definition. The first test is the concentration test, which is an optional simplified assessment. If the condition under the concentration test is **met,** a company can immediately reach the conclusion that the transaction is an asset acquisition. If the test is **not met**, the entity should go through the other two tests, which focus on assessing the existence of relevant skilled workforce and substantive processes.

Concentration Test	Workforce Test	Substantive Process Test
Is substantially all of the fair value of the gross assets acquired concentrated in a single (or group of similar) identifiable asset(s)?	Is there a workforce with skills that are critical for producing or developing into outputs?	Evaluate whether an input and a process together significantly contribute to create outputs

Applying the concentration test may save a lot of work; the most critical and complicated step of the test counts on the identification of the assets acquired

The Concentration Test

Fair value of a single identifiable asset or group of similar identifiable assets

VS

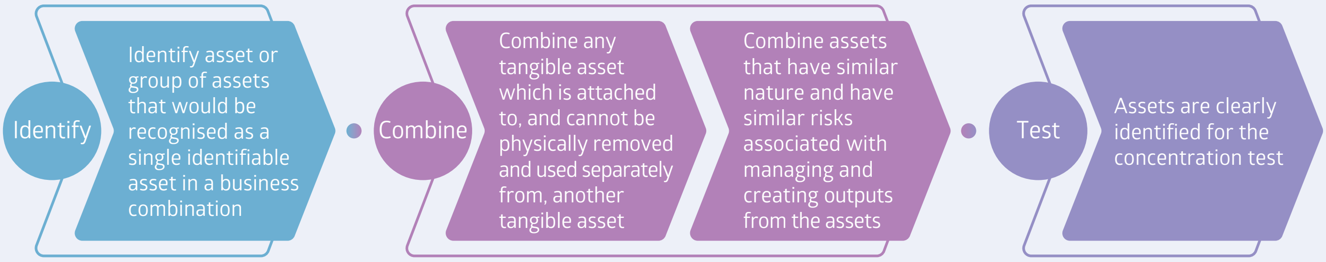
Fair value of the gross assets acquired

The concentration test is a newly added optional test that permits a simplified assessment for determining when a set of activities and assets is not a business. It reduces the cost and complexity by avoiding the need for a detailed assessment. When substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set of activities and assets would not be considered a business. This test serves as a fast track to determine either an asset acquisition or a business combination.

Determining All Identifiable Assets

In order to conduct the concentration test, all assets acquired shall first be identified. This asset identification would apply the same basis that is used for identifying assets recognised in a business combination. The assets identified may be a single asset or a group of similar assets.

Tangible assets and intangible assets (e.g. a nuclear power plant and a licence to operate it) that are combined for recognition in a business combination would also be considered as a single identifiable asset for the purposes of the concentration test.



Once the acquired assets are clearly identified, the rest of the concentration test should be simple and straight forward

Impact on CLP – Acquisition of Power Projects

For every power project acquisition, CLP shall determine whether the transaction is a business combination or an asset acquisition by applying the definition of business. In the past, the application of the definition was sometimes ambiguous. When a transaction was accounted for as business combination, it may have resulted in the recognition of goodwill (usually because of the recognition of deferred tax liabilities), which was difficult to explain from a commercial perspective, especially when acquiring a single power plant project.

CLP believes that the new business definition, which clarifies current vague areas, narrows down the number of transactions being identified as business, and at the same time coupled with the introduction of the concentration test, it provides a relief to companies by simplifying the assessment.

Usually, a power project would come together with a power purchase agreement (PPA) or a transmission service agreement (TSA). When applying the concentration test, CLP needs to identify assets which are qualified to combine. CLP considers the infrastructure and the PPA or TSA with similar useful lives as a single asset. PPA or TSA is not recognised separately from the infrastructure as an intangible asset as it is more in the nature of an embedded operation licence to the power plant. Therefore, PPA or TSA together with the infrastructure are treated as a single identifiable asset when applying the concentration test.

Below are acquisitions which the new business definition has been applied during the year.

Timing of Transaction	Interest Acquired	Acquiree	Asset Type	Consideration	Key Assets Identified	Substantially All of the Fair Value Concentrated?	Conclusion of the Concentration Test
March 2020	100%	Cleansolar Renewable Energy Private Limited	30 MW Solar Farm	HK$112 million (Rs1,084 million)	Solar plant (with PPA embedded)	Yes	Asset acquisition
April 2020	100%	Divine Solren Private Limited	50 MW Solar Farm	HK$126 million (Rs1,245 million)	Solar plant (with PPA embedded)	Yes	Asset acquisition