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FASB Clarifies the Definition of a Business

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On January 5, 2017, the FASB issued ASU 2017-01[1] to clarify the definition of a business in ASC 805.[2] The FASB issued the ASU in response to stakeholder feedback that the definition of a business in ASC 805 is being applied too broadly. In addition, stakeholders said that analyzing transactions under the current definition is difficult and costly. Concerns about the definition of a business were among the primary issues raised in connection with the Financial Accounting Foundation's post-implementation review report on FASB Statement No. 141(R), *Business Combinations* (codified in ASC 805). The amendments in the ASU are intended to make application of the guidance more consistent and cost-efficient.

Editor's Note

The definition of a business in ASC 805 also affects other aspects of accounting, such as disposal transactions, determining reporting units when goodwill is tested for recoverability, and the business scope exception in ASC 810.

Significance of the Standard

An entity uses the definition of a business in ASC 805 in determining whether to account for a transaction as an asset acquisition or a business combination. This distinction is important

[1] FASB Accounting Standards Update No. 2017-01, *Clarifying the Definition of a Business*.

[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

because the accounting for an asset acquisition significantly differs in certain respects from the accounting for a business combination. For example, the acquirer's transaction costs are capitalized in an asset acquisition but are expensed in a business combination. Another difference is that in a business combination, the assets acquired are recognized at fair value and goodwill is recognized; in an asset acquisition, however, the cost of the acquisition is allocated to the assets acquired on a relative fair value basis and no goodwill is recognized. The amendments are expected to cause fewer acquired sets of assets (and liabilities) to be identified as businesses.

Editor's Note

The scope of ASC 610-20 raised questions about the interaction between the definition of a business and the guidance on in-substance nonfinancial assets. The FASB intends to address the accounting for partial sales of real estate and clarify that a business is outside the scope of ASC 610-20 in the second phase of its project on the definition of a business.

Key Provisions of the ASU

The ASU's Basis for Conclusions indicates that the amendments "narrow the definition of a business and provide a framework that gives entities a basis for making reasonable judgments about whether a transaction involves an asset or a business." Specifically, the ASU:

- Provides a "screen" for determining when a set is not a business. The screen requires a determination that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not a business. The screen will reduce the number of transactions that an entity must further evaluate to determine whether they are business combinations or asset acquisitions.
- Specifies that if the screen's threshold is not met, a set cannot be considered a business unless it includes an input and a substantive process that together significantly contribute to the ability to create output. The ASU provides a framework to assist entities in the evaluation of whether both an input and a substantive process are present, and it removes the evaluation of whether a market participant could replace the missing elements.
- Narrows the definition of the term "output" to be consistent with the description of outputs in ASC 606.

The standard also provides examples that illustrate how an entity should apply the amendments in determining whether a set is a business.

"Single Identifiable Asset" or "Group of Similar Identifiable Assets" Screen

As noted above, the ASU provides a screen for determining when a set is not a business. In accordance with the screen, when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or group of similar identifiable assets, the set would not be considered a business. An entity would not further evaluate the set if the screen's threshold is met.

The ASU requires an entity to compare the fair value of a single identifiable asset or group of similar identifiable assets with the gross assets acquired, as opposed to the total consideration paid or net assets, to ensure that debt or other liabilities do not affect the analysis. The gross assets acquired exclude cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. However, they include the consideration transferred in excess of the fair value of the net assets acquired.

The ASU's Basis for Conclusions notes that the assessment may be either qualitative or quantitative. Sometimes, an entity may be able to qualitatively determine that the screen's threshold is met if, for example, all of the fair value would be assigned to a single asset. Alternatively, an entity may be able to qualitatively determine that the fair value of the acquisition would be assigned to multiple dissimilar assets, in which case the screen's threshold would not be met. However, in some cases, an entity would need to perform a quantitative assessment.

Single Identifiable Asset

The ASU states that a "single identifiable asset includes any individual asset or group of assets that could be recognized and measured as a single identifiable asset in a business combination." The standard also provides that the following should be considered a single identifiable asset for purposes of the screen:

a. A tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset (or an intangible asset representing the right to use a tangible asset) without incurring significant cost or significant diminution in utility or fair value to either asset (for example, land and building)

b. In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets.

Group of Similar Identifiable Assets

As stated in the ASU's Basis for Conclusions, the FASB "also decided that the [screen's] threshold could be met if the fair value is concentrated in a group of similar identifiable assets" (i.e., when "an entity acquires, for example, multiple versions of substantially the same asset type instead of . . . one asset").

The Basis for Conclusions further notes that "[a]lthough it was the Board's intent to make the analysis practical, the criteria are intended to weigh the need for practicality with the risk that too many items are grouped together to avoid being considered a business." Accordingly, the FASB provided that the following should not be considered similar assets:

a. A tangible asset and an intangible asset

b. Identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development)

c. A financial asset and a nonfinancial asset

d. Different major classes of financial assets (for example, accounts receivable and marketable securities)

e. Different major classes of tangible assets (for example, inventory, manufacturing equipment, and automobiles)

f. Identifiable assets within the same major asset class that have significantly different risk characteristics.

The example below, which is reproduced from the ASU, illustrates the application of the screen.

Case A: Acquisition of Real Estate

Scenario 1

805-10-55-52 ABC acquires, renovates, leases, sells, and manages real estate properties. ABC acquires a portfolio of 10 single-family homes that each have in-place leases. The only elements included in the acquired set are the 10 single-family homes and the 10 in-place leases. Each single-family home includes the land, building, and property improvements. Each home has a different floor plan, square footage, lot, and interior design. No employees or other assets are acquired.

805-10-55-53 ABC first considers the threshold guidance in paragraphs 805-10-55-5A through 55-5C. ABC concludes that the land, building, property improvements, and in-place leases at each property can be considered a single asset in accordance with paragraph 805-10-55-5B. That is, the building and property improvements are attached to the land and cannot be removed without

incurring significant cost. Additionally, the in-place lease is an intangible asset that should be combined with the related real estate and considered a single asset.

805-10-55-54 ABC also concludes that the 10 single assets (the combined land, building, in-place lease intangible, and property improvements) are similar. Each home has a different floor plan; however, the nature of the assets (all single-family homes) are similar. ABC also concludes that the risks associated with managing and creating outputs are not significantly different. That is, the risks associated with operating the properties and tenant acquisition and management are not significantly different because the types of homes and class of customers are not significantly different. Similarly, the risks associated with operating in the real estate market of the homes acquired are not significantly different. Consequently, ABC concludes that substantially all of the fair value of the gross assets acquired is concentrated in the group of similar identifiable assets; thus, the set is not a business.

Substantive Process

The ASU clarifies that "to be considered a business, the set must include, at a minimum, an input and a *substantive* process that together significantly contribute to the ability to create output" (emphasis added). In addition, the ASU clarifies that a substantive process is capable of being applied to inputs to create outputs and is therefore distinguishable from (1) processes that do not typically create outputs, such as accounting, billing, or payroll, or (2) processes that are considered ancillary or minor in the context of all of the processes required to create outputs.

The standard includes different criteria for entities to evaluate depending on whether a set has outputs.

A Set With No Outputs

When a set does not have outputs (e.g., an early-stage company that has not generated revenues), an entity would need to apply more stringent criteria when determining whether a set has a substantive process. Therefore, to qualify as a business, the set would have "both an input and a substantive process that together significantly contribute to the ability to create outputs only if it includes employees that form an organized workforce and an input that the workforce could develop or convert into output." However, the existence of any employee does not mean that a set without outputs should be considered a business. The "organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process (or group of processes)," which is critical to producing outputs. The ASU notes that in the evaluation of whether an acquired workforce is performing a substantive process, the following factors should be considered:

a. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all the processes required to create outputs.

b. Inputs that employees who form an organized workforce could develop (or are developing) or convert into outputs could include the following:

   1. Intellectual property that could be used to develop a good or service
   2. Resources that could be developed to create outputs
   3. Access to necessary materials or rights that enable the creation of future outputs.

   Examples of inputs that could be developed include technology, mineral interests, real estate, and in-process research and development.

The example below, which is reproduced from the ASU, illustrates the assessment an entity would perform when a set has no outputs.

Case C: Acquisition of Biotech

805-10-55-70 Pharma Co. buys all of the outstanding shares of Biotech. Biotech's operations include research and development activities on several drug compounds that it is developing (in-process research and development projects). The in-process research and development projects are in different phases of the U.S. Food and Drug Administration approval process and would treat significantly different diseases. The set includes senior management and scientists that have the necessary skills, knowledge, or experience to perform research and development

activities. In addition, Biotech has long-lived tangible assets such as a corporate headquarters, a research lab, and lab equipment. Biotech does not yet have a marketable product and, therefore, has not generated revenues. Assume that each research and development project has a significant amount of fair value.

805-10-55-71 Pharma Co. first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The identifiable assets in the set include multiple in-process research and development projects and tangible assets (the corporate headquarters, the research lab, and the lab equipment). Pharma Co. concludes that the in-process research and development projects are not similar assets because the projects have significantly different risks associated with managing the assets and creating the outputs (that is, because there are significantly different development risks in the different phases of development, market risks related to the different customer base, and potential markets for the compounds). In addition, Pharma Co. concludes that there is fair value associated with the acquired workforce because of the proprietary knowledge of and experience with Biotech's ongoing development projects and the potential for creation of new development projects that the workforce embodies. As such, Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and that it must further evaluate whether the set has the minimum requirements to be considered a business.

805-10-55-72 Because the set does not have outputs, Pharma Co. evaluates the criteria in paragraph 805-10-55-5D to determine whether the set has both an input and a substantive process that together significantly contribute to the ability to create outputs. Pharma Co. concludes that the criteria are met because the scientists make up an organized workforce that has the necessary skills, knowledge, or experience to perform processes that when applied to the in-process research and development inputs is critical to the ability to develop those inputs into a product that can be provided to a customer. Pharma Co. also determines that there is a more-than-insignificant amount of goodwill (including the fair value associated with the workforce), which is another indicator that the workforce is performing a critical process. Thus, the set includes both inputs and substantive processes and is a business.

A Set With Outputs

The ASU's Basis for Conclusions indicates that when a set has outputs (i.e., there is a continuation of revenues before and after the transaction), "it is more likely that the set includes both an input and a substantive process when compared with a set that is not generating outputs." Therefore, the criteria for determining whether a set with outputs has a substantive process are less stringent. A set with outputs would include a substantive process if any of the following criteria are met:

a. Employees that form an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all of the processes required to continue producing outputs.

b. An acquired contract that provides access to an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs. An entity should assess the substance of an acquired contract and whether it has effectively acquired an organized workforce that performs a substantive process (for example, considering the duration and the renewal terms of the contract).

c. The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

d. The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and is considered unique or scarce.

An organized workforce may represent a substantive process but is not required if outputs are present. The Basis for Conclusions states, for example, that "an organized workforce might not be required if the set includes automated processes (for example, through acquired technology, infrastructure, or specialized equipment) or other significant processes that contribute to the ability to continue producing outputs."

However, the ASU clarifies that a continuation of revenues alone does not mean that both an input and a substantive process have been acquired. The ASU states that "assumed contractual arrangements that provide for the continuation of revenues (for example, customer contracts, customer lists, and leases [when the set is the lessor]) should be excluded from the analysis . . . of whether a [substantive] process has been acquired."

The example below, which is reproduced from the ASU, illustrates the assessment an entity would perform when a set has outputs.

> **Case F: License of Distribution Rights**
>
> **805-10-55-82** Company A is a distributor of food and beverages. Company A enters into an agreement to sublicense the Latin American distribution rights of Yogurt Brand F to Company B, whereby Company B will distribute Yogurt Brand F in Latin America. As part of the agreement, Company A transfers the existing customer contracts in Latin America to Company B and an at-market supply contract with the producer of Yogurt Brand F. Company A retains all of its employees and distribution capabilities.
>
> **805-10-55-83** Company B first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The identifiable assets that could be recognized in a business combination include the license to distribute Yogurt Brand F, customer contracts, and the supply agreement. Company B concludes that the license and customer contracts will have fair value assigned to them. Company B concludes that neither asset represents substantially all of the fair value of the gross assets. Company B then considers whether the license and customer contracts are a group of similar intangible assets. Because the license and customer contracts are in different major classes of identifiable intangible assets, they are not considered similar assets. Therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets, and Company B must evaluate whether the set has both an input and a substantive process.
>
> **805-10-55-84** The set has outputs through the continuation of revenues with customers in Latin America. As such, Company B must evaluate the criteria in paragraph 805-10-55-5E to determine whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs. Company B considers whether the acquired contracts are providing access to an organized workforce that performs a substantive process. However, because the contracts are not providing a service that applies a process to another acquired input, Company B concludes that the substance of the contracts [is] only that of acquiring inputs. The set is not a business because:
>
> a. It does not include an organized workforce that could meet the criteria in paragraph 805-10-55-5E(a) through (b).
>
> b. There are no acquired processes that could meet the criteria in paragraph 805-10-55-5E(c) through (d).
>
> c. It does not include both an input and a substantive process.

Definition of Output

The ASU changes the definition of an output to the "result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues." This change narrows the definition to be consistent with ASC 606, which, as noted in the ASU's Basis for Conclusions, "describes goods or services that are an output of the entity's ordinary activities." However, not every entity has revenues within the scope of ASC 606. Therefore, the Board decided to incorporate into the definition of output other types of revenues. For example, the reference to investment income in the definition of an output was included to ensure that the purchase of an investment company could still qualify as a business combination.

Convergence With IFRSs

The definition of a business in ASC 805 is currently identical to that in IFRS 3.[3] Nevertheless, the interpretation and application of this term in jurisdictions that apply U.S. GAAP do not appear consistent with those in jurisdictions that apply IFRSs (i.e., the definition of a business

[3] IFRS 3, *Business Combinations*.

in IFRS jurisdictions is not applied as broadly). Although the ASU adds implementation guidance to U.S. GAAP that is not found in IFRSs, the FASB intends to more closely align practice under U.S. GAAP with that under IFRSs by narrowing the application of the U.S. GAAP definition. Further, the IASB has added to its agenda a project on the definition of a business and issued an exposure draft, which proposes amendments similar to those described herein for U.S. GAAP.

Effective Date and Transition

The ASU is effective for public business entities in annual periods beginning after December 15, 2017, including interim periods therein. For all other entities, the ASU is effective in annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. The ASU must be applied prospectively on or after the effective date, and no disclosures for a change in accounting principle are required at transition.

Early adoption is permitted for transactions (i.e., acquisitions or dispositions) that occurred before the issuance date or effective date of the standard if the transactions were not reported in financial statements that have been issued or made available for issuance.

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