Deloitte.

December 4, 2015
Volume 22, Issue 39

Heads Up

In This Issue

FASB Proposes Amendments to Clarify the Definition of a Business

by Lauren Pesa and Stefanie Tamulis, Deloitte & Touche LLP

On November 23, 2015, the FASB issued a proposed ASU[1] that would clarify the definition of a business in ASC 805[2] and provide a framework that an entity can use to determine whether a set of activities and assets (collectively, a "set") constitutes a business.

The FASB issued the proposed ASU in response to stakeholder feedback indicating that the definition of a business in ASC 805 is too broad and that too many transactions are qualifying as business combinations even though many of these transactions may more closely resemble asset acquisitions. Because the current definition has been interpreted broadly, it can be inefficient and costly to analyze transactions and entities may not be able to use "reasonable judgment." The proposed amendments would make application of the guidance more consistent and cost-efficient.

Editor's Note: Concerns about the definition of a business were among the primary issues raised in connection with the FAF's post-implementation review report on FASB Statement No. 141(R), *Business Combinations* (codified in ASC 805).

Significance of the Proposal

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 because the accounting for an asset acquisition significantly differs 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 FASB considered addressing the concern about the definition of a business more directly by attempting to reduce or eliminate differences between the accounting for business combinations and that for asset acquisitions. However, to respond to stakeholder concerns in a timely fashion, the FASB decided to begin this project by clarifying the definition of a business.

[1] FASB Proposed Accounting Standards Update, *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*."

Editor's Note: The definition of a business in ASC 805 also affects other aspects of accounting such as disposal transactions, determining reporting units, and the business scope exception in ASC 810. The proposed amendments would cause fewer sets of assets (and liabilities) to be identified as businesses.

Challenges Related to Applying the Current Definition of a Business

The definition of a business would remain unchanged under the proposed ASU. ASC 805 defines a business 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 current implementation guidance in ASC 805-10-55-4 states that a "business consists of inputs and processes applied to those inputs that have the ability to create outputs." A business has three elements — inputs, processes, and outputs. All businesses have inputs and processes, and most have outputs, but outputs are not required for a set to be a business. Further, ASC 805-10-55-5 states that "all of the inputs or processes that the seller used" in operating the set do not need to be part of the transaction "if market participants are capable of acquiring the [set] and continuing to produce outputs, for example, by integrating the [acquired set] with their own inputs and processes."

The current implementation guidance does not specify the minimum inputs and processes required for a set to meet the definition of a business, which has led some to interpret the definition of a business broadly. Some have said that a set may qualify as a business even if no processes are acquired when revenue-generating activities continue after an acquisition or if a market participant would be capable of integrating the acquired set with its own processes. For example, some believe that the acquisition of real estate with an in-place lease meets the definition of a business because a market participant is capable of acquiring an input (a building with a lease) and combining it with its own processes (processes to collect rent and maintain the building) to continue generating outputs (rental income). Others have said that the presence of any process can give rise to a business, regardless of the significance of that process.

In addition, ASC 805-10-55-4(c) refers to an output as having "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" (emphasis added). Many transactions can provide a return in some form (e.g., the acquisition of a new machine might lower costs). Thus, the definition of outputs has further contributed to broad interpretations of the definition of a business.

Main Provisions of the Proposal

The proposed ASU's Basis for Conclusions indicates that the amendments would "narrow the definition of a business and provide a framework that gives entities a basis for making reasonable judgements about whether a transaction involves an asset or a business." In addition, the proposal provides examples illustrating the application of the amendments to the determination of whether a set is a business.

Single or Similar Asset Threshold

The proposed ASU "would provide a practical way to determine when a [set] is not a business." That is, "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 would not be considered a business. When this threshold is met, an entity would not need to evaluate the rest of the implementation guidance. The Basis for Conclusions notes that the assessment may be either qualitative or quantitative. In some cases, an entity may be able to qualitatively determine that all of the fair value of the acquisition would be assigned to a single asset or a group of similar assets. An entity may also be able to qualitatively determine that the fair value of the acquisition would be assigned to multiple dissimilar assets, in which case the threshold would not be met. In other cases, an entity may need to perform a quantitative assessment.

In addition, the FASB "decided that the threshold could be met if the fair value is concentrated in a group of similar identifiable assets" (e.g., when "an entity acquires, for example, multiple versions of substantially the same asset type instead of . . . one asset"). The Board further notes that although it intended "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."

To avoid inappropriate groupings of assets, the FASB is adding ASC 805-10-55-9C to the proposed ASU. This paragraph indicates that an entity should not combine the following assets into a single asset (or consider them to be similar assets):

a. Tangible and intangible assets (for example, real estate and in-place lease intangibles)
b. Identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development), except for groups of identifiable intangible assets that are recognized and measured as a single identifiable asset in accordance with this Topic (for example, complementary intangible assets that have similar useful lives . . .)
c. Financial and nonfinancial assets
d. Different major classes of financial assets (for example, cash, accounts receivable, and marketable securities)
e. Different major classes of tangible nonfinancial assets (for example, inventory, manufacturing equipment, and automobiles).

The following example (reprinted from the proposed ASU) illustrates how to apply the threshold:

Case A: Acquisition of Single-Family Homes

ABC acquires, renovates, leases, sells, and manages single-family residential homes. ABC acquires a portfolio of 10 single-family homes that each have at-market 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.

ABC first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. ABC must first determine whether each single-family home would be considered a single asset for purposes of this analysis. ABC concludes that the land, building, and property improvements can be considered a single asset in accordance with paragraph 805-10-55-9B. That is, the building and property improvements are attached to the land and cannot be removed without incurring significant cost. However, the in-place lease is an intangible asset and cannot be combined with the tangible real estate in accordance with paragraph 805-10-55-9C.

ABC then considers whether the 10 tangible assets (the combined land, building, and property improvements) are similar. Each home is different; however, the nature of the assets (all single-family homes) are similar. As such, ABC concludes that the group of 10 single-family homes is a group of similar assets.

Next, ABC compares the fair value of the group of similar tangible assets with the fair value of the total gross assets acquired (the combined tangible assets plus the 10 in-place lease assets) and concludes that substantially all of the fair value of the gross assets acquired is concentrated in the group of similar tangible assets. That is, the in-place leases in this Example do not have significant fair value. As such, the set is not a business.

Substantive Process

The proposed amendments would clarify that to be "a business, a transaction must include, at a minimum, an input and a *substantive* process" (emphasis added). Further, the Board points out that "the existence of a process (or processes) is what distinguishes a business from an asset because all asset acquisitions have inputs, and, therefore, providing additional guidance related to processes should help differentiate between [groups of] assets and businesses."

The proposed amendments would not change the definition of process, but they would add two different sets of criteria for entities to consider in determining whether a set has a substantive process; these criteria depend on whether a set has outputs.

A Set With No Outputs

When outputs are not present, an entity would need to apply more stringent criteria when determining whether a set has a substantive process (e.g., an early-stage company that has not generated revenues). The proposal points out that "[b]ecause outputs are a key element of a business and [because] a business usually has outputs, . . . when that key element is missing, the other elements should be more significant." Therefore, to qualify as a business, a set that does not have outputs would need to have both an input and a substantive process. The set would include a substantive process "if it includes an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that, when applied to another acquired input or inputs, is critical to the ability to develop or convert that acquired input or inputs into outputs." The existence of any employee does not mean that a set without outputs should be considered a business. The proposal 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 the organized workforce could develop (or is 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 could include technology, mineral interests, real estate, or in-process research and development.

The following example (reprinted from the proposed ASU) illustrates the assessment an entity would perform when a set has no outputs:

Case E: Acquisition of Biotech

Pharma Co. buys all of the outstanding shares of Target Biotech. Target Biotech's operations include research and development activities on several preclinical compounds that it is developing (in-process research and development projects). The set includes the scientists that have the necessary skills, knowledge, or experience to perform research and development activities. In addition, Target Biotech has long-lived tangible assets such as a corporate headquarters, a research lab, and testing equipment. Target Biotech does not yet have a marketable product and, therefore, has not generated revenues.

Pharma Co. first considers the guidance in paragraph 805-10-55-9A and analyzes whether 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 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). In addition, Pharma Co. concludes that there is fair value associated with the acquired workforce. Pharma Co. also 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. Furthermore, because of the significant amount of fair value associated with both the tangible assets and the acquired workforce, Pharma Co. does

> not assess whether the in-process research and development projects are similar (because even if those projects were similar, the threshold would not be met).
>
> Because the set does not have outputs, Pharma Co. evaluates the criteria in paragraph 805-10-55-5A to determine whether the set has both an input and a substantive process. Big Pharma concludes that the criteria in paragraph 805-10-55-5A 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 good that can be provided to a customer. The presence of a more than insignificant amount of goodwill 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 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. ASC 805-10-55-5B (added by the proposed ASU) indicates that the set would include a substantive process if any of the following criteria are met:

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

An organized workforce may signify the existence of a substantive process but would not be 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."

Further, ASC 805-10-55-5C (added by the proposed ASU) states, in part:

> If a set has outputs, a continuation of revenues does not, on its own, indicate that both an input and a substantive process have been acquired. Accordingly, 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 following example (reprinted from the proposed ASU) illustrates the assessment an entity would perform when a set has outputs:

> **Case F: License of Distribution Rights**
>
> Company A is a global producer of food and beverages. Company A enters into an agreement to license the Latin American distribution rights of Yogurt Brand F to Company B whereby Company B will be the exclusive distributor of Yogurt Brand F in Latin America. As part of the agreement, Company A transfers the existing customer contracts in Latin America to Company B. Companies A and B also enter into an at-market supply contract in which Company B will purchase all of Yogurt Brand F from Company A. Company A retains all of its manufacturing and distribution capabilities. That is, Company B does not acquire manufacturing inputs and processes or distribution inputs and processes (and does not have any of the intellectual property related to those processes or to direct Company A's processes in any way) but only will purchase finished goods from Company A that it will sell and distribute to end customers in Latin America.

Company B first considers the guidance in paragraph 805-10-55-9A and analyzes whether 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 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 only the license and customer contracts would have fair value assigned to them and 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 would not be 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.

The set has outputs through the continuation of revenues with customers in Latin America. As such, Company B must evaluate the criteria in paragraph 805-10-55-5B to determine whether the set includes an input and a substantive process that together contribute to the ability to create outputs. Because the customer contracts are excluded from the determination of whether a process is present in accordance with paragraph 805-10-55-5C, the only elements in the set to evaluate to determine whether a substantive process is present are the license and supply agreement, both of which are inputs. That is, Company B did not obtain any process that could be applied to an acquired input to produce or distribute Yogurt Brand F but, rather, only a right to distribute and the access to purchase Yogurt Brand F. Because the set does not include an organized workforce and there are no acquired processes that could meet the criteria in paragraph 805-10-55-5B(b) through (c), the set is not a business because it does not include both an input and a substantive process.

Definition of Outputs

The proposed amendments would change the definition of outputs to "[t]he result of inputs and processes applied to those inputs that provide goods or services to customers, other revenues, or investment income, such as dividends or interest." The definition of outputs would be narrowed to be consistent with ASC 606, which "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 outputs other types of revenues. For example, the reference to investment income in the definition of outputs in the proposed amendments was included to ensure that the purchase of an investment company could still qualify as a business combination.

Next Steps

Comments on the proposed ASU are due by January 22, 2016. An entity would apply the proposed amendments prospectively to any transaction that occurs on or after the effective date and would not be required to provide any disclosures at transition. The proposal notes that the FASB "will determine the effective date and whether the proposed amendments may be applied before the effective date after it considers stakeholder feedback on the proposed amendments."

At a later date, the Board will discuss clarifying the guidance on partial sales or transfers of assets that are within the scope of ASC 610-20 as well as the corresponding accounting for the retained interests. The FASB also plans to discuss aligning the accounting for acquisitions of assets with that for businesses.

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 in IFRS jurisdictions is not applied as broadly). Although the proposed ASU would add 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 application of the U.S. GAAP definition. Further, the IASB has added a project on the definition of a business to its agenda and is considering making amendments similar to those in the proposed ASU.

[3] IFRS 3, *Business Combinations*.

Subscriptions

If you wish to subscribe to *Heads Up* and other Deloitte accounting publications, please register at www.deloitte.com/us/subscriptions.

Dbriefs for Financial Executives

We invite you to participate in *Dbriefs*, Deloitte's webcast series that delivers practical strategies you need to stay on top of important issues. Gain access to valuable ideas and critical information from webcasts in the "Financial Executives" series on the following topics:

- Business strategy and tax.
- Driving enterprise value.
- Financial reporting.
- Financial reporting for taxes.
- Governance, risk, and compliance.
- Technology.
- Transactions and business events.

Dbriefs also provides a convenient and flexible way to earn CPE credit — right at your desk. Subscribe to *Dbriefs* to receive notifications about future webcasts at www.deloitte.com/us/dbriefs.

Technical Library and US GAAP Plus

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, EITF, AICPA, PCAOB, IASB, and SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. Technical Library subscribers also receive Technically Speaking, the weekly publication that highlights recent additions to the library. For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.

In addition, be sure to visit US GAAP Plus, our free Web site that features accounting news, information, and publications with a U.S. GAAP focus. It contains articles on FASB activities and updates to the *FASB Accounting Standards Codification*™ as well as developments of other U.S. and international standard setters and regulators, such as the PCAOB, AICPA, SEC, IASB, and IFRS Interpretations Committee. Check it out today!