To the Point
FASB – final guidance

FASB narrows the definition of a business

The revised definition of a business will reduce the number of transactions that are accounted for as business combinations.

What you need to know

- The FASB issued new guidance that changes the definition of a business to assist entities with evaluating when a set of transferred assets and activities is a business.
- The guidance requires an entity to evaluate if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets; if so, the set of transferred assets and activities is not a business. The guidance also requires a business to include at least one substantive process and narrows the definition of outputs by more closely aligning it with how outputs are described in ASC 606.¹
- The guidance is effective for public business entities for fiscal years beginning after 15 December 2017, and interim periods within those years. For all other entities, it is effective for fiscal years beginning after 15 December 2018, and interim periods within fiscal years beginning after 15 December 2019. Early adoption is permitted.

Overview
The Financial Accounting Standards Board (FASB or Board) issued an Accounting Standards Update² (ASU) that provides guidance to assist entities with evaluating when a set of transferred assets and activities (set) is a business. In doing so, the FASB responded to constituents’ concerns that the definition of a business was too broad and challenging to apply.

¹ FASB, “The revised definition of a business will reduce the number of transactions that are accounted for as business combinations.”
² FASB, “Overview”
Under the new guidance, an entity first determines whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. If this threshold is met, the set is not a business. If it’s not met, the entity then evaluates whether the set meets the requirement that a business include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs.

**Background**

Determining whether a set constitutes a business under Accounting Standards Codification (ASC) 805 is critical because the accounting for a business combination differs significantly from that of an asset acquisition. For example, transaction costs are capitalized in an asset acquisition but expensed in a business combination; in-process research and development (IPR&D) is capitalized in a business combination but expensed in an asset acquisition; and contingent consideration is recognized at its acquisition date fair value in a business combination but is generally recognized in an asset acquisition when the contingency is resolved. The definition of a business also affects the accounting for dispositions and the identification of reporting units. It also may affect how a reporting entity applies the consolidation guidance.

Today’s implementation guidance states that a business consists of (1) inputs, (2) processes applied to those inputs and (3) the ability to create outputs. While a business usually has outputs, they are not required for the set to be a business. Further, not all inputs and processes needed to operate the set as a business are required if a market participant could replace the missing elements.

**Key considerations**

**‘Substantially all’ threshold**

Under today’s guidance, it doesn’t matter whether all the value relates primarily to one asset. Under the ASU, a set is not a business when substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. The ASU includes guidance on which types of assets can and cannot be combined into a single identifiable asset or a group of similar identifiable assets for the purpose of applying the threshold. The following illustration summarizes Case B, Scenario 1, in the ASU:

<table>
<thead>
<tr>
<th>Illustration 1 – The application of the threshold</th>
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<td>Pharma Co. purchases a legal entity that holds a Phase 3 compound developed to treat diabetes, an at-market clinical research organization (CRO) contract and an at-market clinical manufacturing organization (CMO) contract. No other assets or activities are transferred. No employees are transferred.</td>
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<td>Pharma Co. concludes that the IPR&amp;D related to the compound (including the historical know-how, formulas, protocols, designs and related procedures) is a single identifiable intangible asset. Pharma Co. concludes there is no value to assign to the at-market CRO and CMO contracts and that all of the value of the gross assets acquired is concentrated in the IPR&amp;D asset. Therefore, the acquired set is not a business, and no further analysis is required.</td>
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How we see it

- Adding the threshold provides a practical approach to determining when certain sets do not constitute a business.
- Determining which assets can be combined and considered a single asset or a group of similar assets for purposes of applying the threshold may require significant judgment.

Processes required

ASC 805 states that not all processes are required to be included in a set for it to be considered a business but does not specify the minimum processes required or provide guidance on the types of processes that should be included. The ASU requires that, to be a business, the set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. An acquired process (or a group of processes) would be considered substantive when:

- A set is not generating outputs but includes employees that form an organized workforce with the necessary skills, knowledge or experience to perform an acquired process (or group of processes) that, when applied to an acquired input, is critical to the ability to develop or convert that input into outputs. However, an acquired contract that provides access to an organized workforce would not be considered a substantive process when the set is not generating outputs.
- The set has outputs (i.e., revenue is generated before and after the transaction) and includes any of the following:
  - Employees that form an organized workforce or 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, is critical to the ability to continue producing outputs
  - A process (or group of processes) that, when applied to an acquired input, 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
  - A process (or group of processes) that, when applied to an acquired input, significantly contributes to the ability to continue producing outputs and is considered unique or scarce

Under the ASU, even when a set has outputs, an acquirer does not presume that a set with a continuing revenue stream includes a substantive process. Rather, an acquirer uses the factors described above to determine whether there is a substantive process.

The overall evaluation of whether a set is a business continues to be performed from the perspective of a market participant. That is, how a seller operated the set or how the buyer intends to operate the set does not affect the analysis (consistent with today’s requirements). However, the ASU eliminates the requirement to evaluate whether a market participant could replace any missing elements.
The following illustration summarizes Case A, Scenario 2, in the ASU:

**Illustration 2 – Analysis of whether substantive process is present**

ABC acquires a portfolio of 10 single-family homes that each has in-place leases and an office park with six 10-story office buildings that are leased to maximum occupancy. ABC assumes the existing outsourced cleaning and security contracts for the properties. No other elements (e.g., employees, assets, substantive processes) are included in the acquired set.

ABC applies the threshold and determines 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. Because the continuation of revenues does not, on its own, indicate that a substantive process has been transferred, ABC must evaluate whether it has acquired a substantive process.

ABC determines that the processes performed through the cleaning and security contracts are not critical in the context of all of the processes required to create outputs. ABC also determines that the cleaning and security processes could be easily replaced with little cost, effort or delay in the set’s ability to continue producing outputs and are not unique or scarce. As a result, ABC concludes that the set does not include a substantive process and, therefore, is not a business.

**How we see it**

In practice today, if revenues are generated immediately before and after a transaction, the set is typically considered a business. Requiring entities to further assess the substance of the processes they acquire likely will reduce the number of transactions accounted for as business combinations but may require more judgment.

**Definition of outputs**

The ASU defines an output as “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.” The Board was concerned that today’s definition could lead to any form of return being considered an output (e.g., lower costs from a new machine). To address that concern, the ASU more closely aligns the definition of outputs with how they are described in the new revenue guidance in ASC 606 by focusing on revenue-generating activities.

**Transition and effective date**

The ASU is effective for public business entities for fiscal years beginning after 15 December 2017, and interim periods within those years. For all other entities, it is effective for fiscal years beginning after 15 December 2018, and interim periods within fiscal years beginning after 15 December 2019. The ASU will be applied prospectively to any transactions occurring within the period of adoption. Early adoption is permitted, including for interim or annual periods in which the financial statements have not been issued or made available for issuance.

**Endnotes:**

1. ASC 606, Revenue from Contracts with Customers.
3. ASC 805, Business Combinations.
4. ASC 805 currently defines an output as “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.”