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Technical Line

Applying the definition of a business to oil and gas transactions

In this issue:

What you need to know

- Applying the new definition of a business may not reduce the number of oil and gas transactions that need to be accounted for as business combinations.
- Upstream oil and gas entities that have adopted the guidance have found that they need to exercise significant judgment to apply the threshold for determining whether a set of transferred assets is not a business. They need to evaluate the risk characteristics of acquired properties, which can be challenging.
- Midstream oil and gas entities need to evaluate whether transferred assets that wouldn't be a single identifiable asset in a business combination should be combined into a single identifiable asset for the purpose of applying the threshold. When the threshold is not met, the presence of a SCADA system may represent a substantive process.
- The guidance is effective for entities that are not public business entities for fiscal years beginning after 15 December 2018 and interim periods within fiscal years beginning after 15 December 2019.

Overview

The guidance created by Accounting Standards Update (ASU) 2017-01[1] is intended to assist entities with evaluating whether a set of transferred assets and activities (set) is a business.

While the new guidance was generally expected to result in more transactions being accounted for as asset acquisitions rather than business combinations, oil and gas entities that have adopted the guidance have found that this may not always be the case for transactions in their industry. Additionally, entities have found that significant judgment is required to determine whether a set is a business, in particular when determining whether the "substantially all" threshold is met.

Applying the 'substantially all' threshold requires significant judgment.

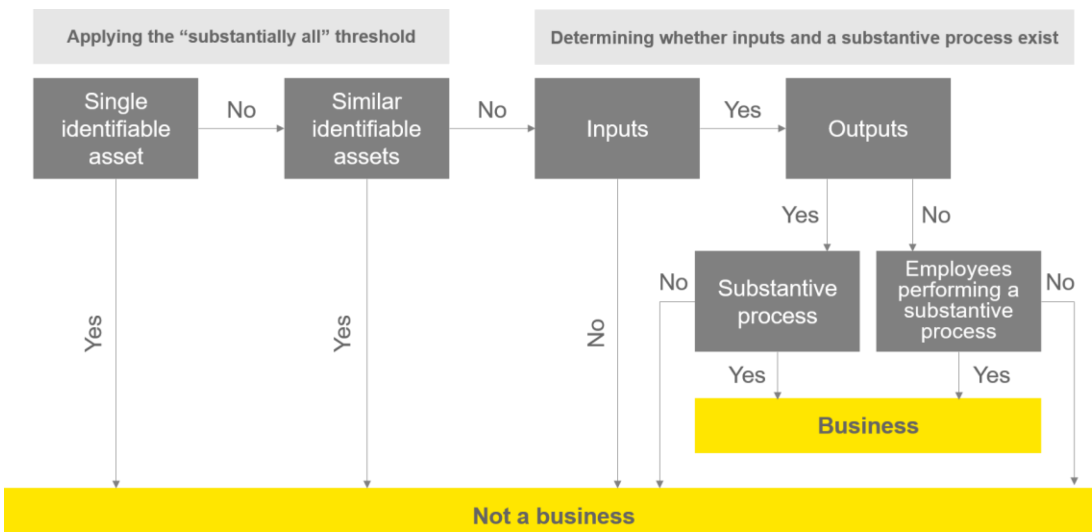
Background

Under the 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 "substantially all" threshold is met, the set is not a business. If the threshold is not met, the entity further evaluates whether the set meets the definition of a business.

Determining whether a set of acquired assets is a business under Accounting Standards Codification (ASC) 805[2] 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.

See the Appendix for a list of the key differences between the accounting for business combinations and asset acquisitions. The definition of a business also affects dispositions of assets, the identification of reporting units and the application of consolidation guidance.

The following graphic illustrates how to generally apply the definition of a business.



Considerations for upstream transactions

Nature of upstream transactions

Upstream oil and gas entities engage in the exploration and production of oil and gas properties. The development of oil and gas properties is very capital intensive. Oil and gas entities often enter into joint arrangements to share in the risks and rewards of individual properties or groups of properties that contain undeveloped minerals (e.g., oil, gas).

In the US, these arrangements often are governed by joint operating agreements. A joint operating agreement (JOA) is an agreement that assigns the role of "operator" to one party (often, though not always, the party with the largest working interest). All other parties are referred to as non-operators. The operator and non-operators each own undivided interests in the minerals to be extracted.

Mineral interests may include royalty interests (the holder is entitled to a share of production) or working interests (the holder bears a share of the costs of developing and operating property and is entitled to a share of its production). Generally, mineral interests are sold at the property level because that is the level at which the undivided interest exists. However, mineral interests sold in a single transaction can be associated with a particular field or basin or can span various geographical regions.

Applying the substantially all threshold

The guidance requires an entity to first evaluate 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 that threshold is met, the set is not a business and does not require further evaluation.

Single identifiable asset

An entity must determine the identifiable assets in the set. In doing so, an entity will identify assets or groups of assets that could be recognized and measured as a single identifiable asset in a business combination accounted for under ASC 805.

The guidance also requires entities to combine the following assets and consider them a single identifiable asset for purposes of applying the threshold, even though they would not be combined into a single identifiable asset in a business combination:

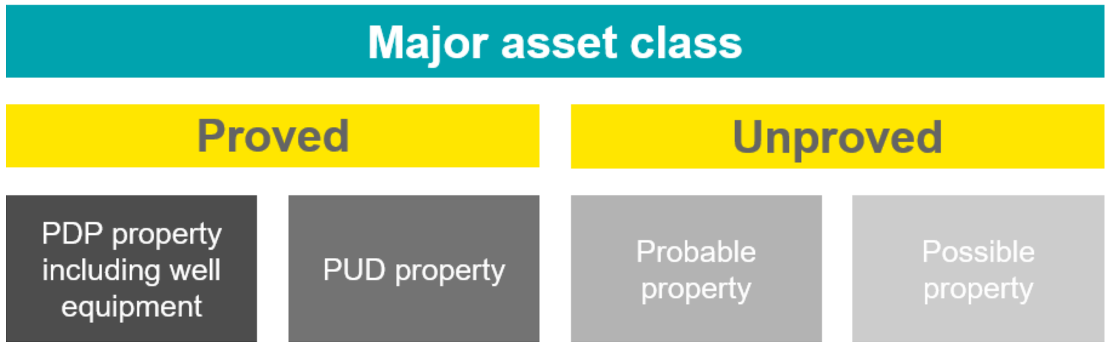
- Two tangible assets that are attached and cannot be used separately without incurring significant cost or significant diminution in the utility or fair value of either asset (or an intangible asset representing the right to use a tangible asset that cannot be used separately from the tangible asset), such as land and a building
- In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities (i.e., an off-market component), and the related leased assets

The assets that are transferred in an upstream transaction generally will consist of mineral interests (both proved properties and unproved properties) and may include well equipment when proved developed producing (PDP) properties are included in the set. Each of these assets may represent separate identifiable assets that would be recognized and measured in a business combination.

Applying the guidance described above, upstream entities need to determine whether there are tangible assets in the set that cannot be used separately without incurring significant cost or significant diminution in the utility or fair value of either asset.[3] When a set includes a PDP interest and well equipment that is attached to the property, those tangible assets generally will meet the criteria to be considered a single identifiable asset for purposes of applying the threshold.

For purposes of this publication, the term "property" is a single identifiable asset that consists of a mineral interest and the related well equipment (if applicable). An upstream entity's determination of single identifiable assets in the set will require judgment and depend on the facts and circumstances of the transaction (e.g., type of ownership interest, nature, location, geological formation).

The following graphic illustrates the single identifiable assets frequently acquired in an upstream oil and gas transaction.



Similar identifiable assets

In evaluating whether the threshold is met, an entity also must determine whether any single identifiable assets would be considered similar to another asset and would be combined into a group for purposes of applying the threshold. When evaluating whether assets are similar, an entity should consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets. This evaluation will require significant judgment.

Oil and gas entities should consider reserve categories and the nature and location of properties when determining whether single identifiable assets are similar.

While the guidance provides a framework for evaluating whether assets are similar, the guidance states that the following assets *cannot* be considered similar:

- A tangible asset and an intangible asset
- Identifiable intangible assets in different major intangible asset classes (e.g., customer-related intangibles, trademarks, in-process research and development (IPR&D))
- A financial asset and a nonfinancial asset
- Different major classes of financial assets (e.g., accounts receivable and marketable securities)
- Different major classes of tangible assets
- Identifiable assets in the same major asset class that have significantly different risk characteristics

ASC 932[4] defines major classes of assets for oil and gas entities to be mineral interests in properties (both proved and unproved), wells and related equipment, support equipment and facilities and uncompleted wells, equipment and facilities.[5] Multiple properties may be transferred in an upstream oil and gas transaction. By definition, mineral interests in proved and unproved properties are in the same major asset class. However, if the risk characteristics are significantly different across properties included in the set, the properties cannot be considered similar for the purpose of applying the threshold.

Upstream oil and gas entities may consider the following risk characteristics when determining whether the assets included in a set are similar. These factors are not intended to be all inclusive, and entities should consider the significance of each factor based on the facts and circumstances of the transaction:

- **Reserve category** — Properties are broadly categorized as proved (PDP reserves or proved undeveloped (PUD) reserves) or unproved (probable reserves or possible reserves). While all properties are in the same major asset class, judgment may be required to determine whether the properties in different reserve categories have significantly different risk characteristics associated with managing and creating outputs. Properties classified in different reserve categories generally have different risk characteristics because the likelihood of successfully extracting hydrocarbons is different and the development risk, in some cases, is different.

- **PDP and PUD properties** — While PDP and PUD properties are both classified as proved, entities should evaluate whether there are significantly different risks associated with managing and creating outputs from these assets. While the risk of successfully extracting hydrocarbons for PDP and PUD properties may not be significantly different, entities should consider differences in other risk characteristics (e.g., development risk). In making this evaluation, entities should consider the location, nature and stage of development of the properties (see below for additional information on nature and location of properties).
- **PUD and probable properties** — When a probable property is geologically and geophysically equivalent to a PUD property but cannot be classified as a PUD property solely because the entity cannot assert that it has made a final investment decision to develop the property within five years,[6] an entity may conclude that a probable property has risk characteristics, including development risk, similar to the related PUD property, and the properties would therefore be combined into a group of similar assets for the threshold evaluation.

- **Nature and location of properties** — Upstream oil and gas entities should consider the nature (i.e., type of commodity (oil or gas)) and location of properties when determining whether they are similar. Properties in different locations may have different risk characteristics associated with development, the geopolitical climate and how the commodity is marketed to customers. Examples of properties that could have different risk characteristics include:
  - Onshore and offshore properties
  - Properties requiring conventional or unconventional development
  - Properties with different risk of developmental dry holes
  - Properties, such as oil sands and coal bed methane, that are different in nature
  - Properties subject to joint development arrangements that subject the entity to different risks, such as traditional US JOAs and production-sharing arrangements with national oil companies
  - Properties in countries with different political environments

Gross assets acquired

Gross assets acquired include any consideration transferred (plus the fair value of any noncontrolling interest and previously held interest, if any) in excess of the fair value of the net identifiable assets acquired. In determining consideration transferred for the purpose of applying the threshold, entities must include all forms of consideration (e.g., cash, contingent consideration) that would be recognized in a business combination. Consideration transferred would not be affected by elements that are part of a separate transaction (e.g., equity awards that represent compensation for future services).

Gross assets acquired exclude cash and cash equivalents, deferred tax assets and any goodwill that would be created in a business combination from the recognition of deferred tax liabilities.

The following examples illustrate the application of the substantially all threshold. The facts in the first two examples are simpler than many transactions in the oil and gas industry. That is, transactions in the industry frequently include the transfer of properties in different reserve categories, as in Illustration 3 below.

Illustration 1 — Evaluating the application of the threshold in an upstream transaction

Upstream Co. acquires a set of assets in a single onshore geological formation, and the fair value of these assets is allocated as follows:

- 80% PDP properties
- 20% PUD properties

Application of the substantially all threshold

Upstream Co. concludes that each property is a single identifiable asset. All of the assets are proved oil and gas properties and they are in the same major asset class. The PUD properties meet the five-year requirement for classification as proved properties (i.e., they have the same likelihood of successfully extracting hydrocarbons as the PDP properties). Additionally, Upstream Co. evaluates whether the PUD properties have significantly different risks associated with development when compared with the PDP properties. The PUD properties are in the final stages of development and are in the same geological formation as the PDP properties. As a result, Upstream Co. concludes that the PUD properties do not have significantly different risks characteristics compared with the PDP properties.

Therefore, Upstream Co. concludes that these assets (PDP and PUD properties) are a group of similar assets. Since the fair value of the gross assets acquired is concentrated in a group of similar assets, the set is not a business.

Illustration 2 — Evaluating the application of the threshold in an upstream transaction

Upstream Co. acquires a set of assets, and the fair value of these assets is allocated as follows:

- 60% PDP properties
- 10% PUD properties
- 30% probable properties

All properties are in a single onshore geological formation. The probable properties have all the technical requirements to be classified as PUDs but, because management has not reached a final investment decision to develop the properties within five years, they cannot be classified as PUDs. In addition, there is not a high developmental risk of dry holes in this formation.

Application of the substantially all threshold

Upstream Co. concludes that each property represents a single identifiable asset. As in Illustration 1, Upstream Co. concludes that the PDP and PUD properties are similar because they are proved oil and gas properties in the same major asset class and have similar risk characteristics.

Next, Upstream Co. evaluates whether the unproved (probable) properties have significantly different risk characteristics from the proved properties. Upstream Co. determines that the likelihood of successfully extracting hydrocarbons for probable properties is the same as for proved properties (i.e., the only reason the probable properties are not classified as PUD properties is because management has not reached a final investment decision to develop the properties within five years). In addition, all properties are in the same geological formation that has a low risk of dry holes and have low development risk.

Therefore, Upstream Co. concludes that the PDP properties, PUD properties and probable properties are similar because they do not have significantly different risk characteristics. Because the fair value of the gross assets acquired is concentrated in a group of similar assets, the set is not a business.

Many oil and gas transactions include assets that may have significantly different risk characteristics such that the substantially all threshold will not be met.

Illustration 3 — Evaluating the application of the threshold in an upstream transaction

Upstream Co. acquires a set of assets and the fair value of these assets is allocated as follows:

- 60% PDP properties
- 10% PUD properties
- 10% probable properties
- 20% possible properties

All properties are located in a single onshore geological formation. However, the formation is considered higher risk, and unproved development in the area has a high rate of exploratory dry holes.

Application of the substantially all threshold

Upstream Co. concludes that each property represents a single identifiable asset. As in Illustration 2, Upstream Co. concludes that each of the PDP and PUD properties is similar because they are proved oil and gas properties in the same major asset class and have similar risk characteristics.

Upstream Co. then evaluates whether the risk characteristics of the unproved (probable and possible) properties differ significantly from the risk characteristics of the proved properties. Due to the high rate of dry holes in the formation for probable and possible properties, there is significantly greater risk associated with successfully extracting hydrocarbons from these properties than from the proved properties. In addition, because the rate of dry holes is higher for the possible properties than for the probable properties, these two categories of properties have significantly different risk characteristics too.

However, Upstream Co. concludes that each of the probable properties is similar, and each of the possible properties is similar because they are in the same major asset class and have similar risk characteristics (i.e., they are in the same reserve category, the likelihood of successfully extracting hydrocarbons is the same and the development risk is the same). As a result, Upstream Co. concludes that there are three groups of similar assets: (1) the PDP and PUD properties, (2) the probable properties and (3) the possible properties.

Upstream 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 assets. Upstream Co. must then evaluate whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs. See Illustration 6 for continued analysis of this fact pattern.

How we see it

Many oil and gas transactions involve the transfer of identifiable assets in the same major asset class that have different risk profiles (e.g., proved and unproved properties). Determining which assets can be combined into a group of similar identifiable assets for the purpose of applying the threshold may require significant judgment based on the facts and circumstances. PDP and PUD properties may be considered similar if an entity concludes that they do not have significantly different risk characteristics.

Determining whether inputs and a substantive process exist

The guidance requires that, to be a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. Because asset acquisitions generally include inputs, the existence of a substantive process is what distinguishes an asset or group of assets from a business.

The guidance provides different criteria for determining whether sets with outputs and those without outputs include a substantive process. Because outputs are a key element of a business, when that element is missing, entities would have to meet a higher standard to conclude that a substantive process is present.

The guidance 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."[7]

Determining which set of criteria to apply (i.e., guidance for sets with outputs or without outputs) may require judgment. In certain cases, a set may produce an insignificant amount of outputs relative to the fair value of all properties acquired in the set. For example, oil and gas transactions may contain PDP properties that are producing a minimal amount of salable hydrocarbons. Generally, entities drill on these properties to retain the rights to future development of the property (i.e., the mineral lease contract has frequency provisions or required drilling schedules). We believe that, depending on the facts and circumstances, an entity could conclude that because the outputs are so insignificant, it would be appropriate to evaluate whether a substantive process exists using the model for sets not generating outputs.

Illustration 4 — Consideration of outputs for upstream transactions

Upstream Co. acquires a set of assets, and the fair value of these assets is allocated as follows:

- 2% PDP properties
- 30% PUD properties
- 50% probable properties
- 18% possible properties

All properties are located in a single onshore geological formation. However, the formation is considered higher risk, and unproved development in the area has a high rate of dry holes. Upstream Co. is required to extract a minimal amount of hydrocarbons to retain rights to future development of the property, due to frequency provisions included in the mineral lease contract. Satisfying these contractual requirements is the sole reason that properties in the set have production.

Application of the substantially all threshold

As in Illustration 3, Upstream Co. concludes that there are three groups of similar assets: (1) the PDP and PUD properties, (2) the probable properties and (3) the possible properties.

Upstream Co. determines that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar assets. Upstream Co. must then evaluate whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs.

Determination of whether an input and substantive process exist

Upstream Co. determines that the outputs (the PDP properties are producing oil) are so insignificant in the context of the set (e.g., the fair value of the producing properties compared with the fair value of the set). Therefore, Upstream Co. will evaluate whether the set includes an input and substantive process by applying the guidance for sets not generating outputs. See Illustration 5 for continued analysis of this fact pattern.

When the set is not generating outputs

When there are no outputs, an acquired process (or group of processes) will be considered substantive if the set includes employees with the necessary skills, knowledge or experience to perform an acquired process that is critical to the ability to develop or convert an acquired input or inputs into outputs. Entities must consider the facts and circumstances to determine whether employees perform or are capable of performing a substantive process.

If there are no outputs, an entity cannot consider an organized workforce provided by an acquired contract (i.e., an outsourced workforce) in its assessment of whether the set includes a substantive process. An employee is needed to oversee an outsourced workforce. If a set without outputs includes both employees and an outsourced workforce, entities will have to apply judgment to determine whether the employees are an organized workforce that provides a substantive process.

Illustration 5 — Consideration of outputs for upstream transactions

Assume the same facts and conclusions as in Illustration 4.

Determination of whether an input and substantive process exist

As described above, Upstream Co. evaluates whether the set includes an input and substantive process by applying the guidance for sets not generating outputs. Upstream Co. concludes that the set does not contain a substantive process because it does not include employees who form an organized workforce. Therefore, the set is not a business.

How we see it

- Upstream oil and gas transactions with no production (i.e., no outputs) rarely include the transfer of employees. Therefore, those sets would not contain a substantive process and would not be businesses.
- We believe that when outputs are so insignificant relative to the fair value of properties in the acquired set, an entity could conclude that it is appropriate to evaluate whether a substantive process exists using the model for sets not generating outputs.

When the set is generating outputs

An acquired process (or group of processes) will be considered substantive when the set has outputs and includes any of the following:

- Employees who 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

The Financial Accounting Standards Board (Board) clarified in the Background Information and Basis for Conclusions of ASU 2017-01[8] that automated processes such as acquired technology, infrastructure or specialized equipment could be considered substantive processes.

Tangible well equipment transferred with producing properties generally functions as a substantive process.

The Board concluded that a set that generates outputs before and after a transaction is more likely to include an input and substantive process than a set that is not generating outputs. Therefore, the criteria are less stringent than those for a set that isn't producing outputs, and a substantive process can exist if any one of the above criteria are met. For example, a set that includes a producing oil and gas property could have a substantive process even if it doesn't include employees who form an organized workforce.

Illustration 6 — Determining whether inputs and a substantive process exist in an upstream transaction

Assume the same facts and conclusions as in Illustration 3.

Determination of whether an input and substantive process exist

Because 60% of the set includes PDPs, the set is generating outputs. Therefore, Upstream Co. evaluates whether the set includes an input and substantive process by applying the guidance for sets generating outputs.

Upstream Co. determines that the set includes inputs (the properties, which include well equipment) and substantive processes. The equipment associated with the PDPs, while an input, also performs an automated process that significantly contributes to the production of outputs and cannot be replaced without significant cost, effort and delay in the ability to continue producing outputs. Therefore, the set is a business.

How we see it

We believe that sets in upstream oil and gas transactions that involve the transfer of producing properties that do not meet the substantially all threshold evaluation will generally be a business, because the tangible well equipment performs an automated process that is a substantive process.

The following illustration shows how an upstream entity would apply all of the guidance described above.

Illustration 7 — Comprehensive upstream oil and gas illustration

Upstream Co. acquires the following set of acreage blocks: Block A is in one onshore geological formation, and Blocks B and C are in a different onshore geological formation.

The PUD properties meet the five-year requirement for classification as proved properties (i.e., they have the same likelihood of successfully extracting hydrocarbons as the PDP properties). The probable reserves associated with Block A have all the technical requirements to be classified as PUDs, but they are not because management has not reached a final investment decision to develop the blocks within five years. All other probable reserves have significantly different risk profiles than the PUD reserves in the same property group. The fair value allocated to Blocks A, B and C is 50%, 30% and 20%, respectively. For purposes of this illustration, assume each block involves only a single property in each property type.

		Property Type		
Block	**Well Equipment**	**PDP**	**PUD**	**Probable**
A	✓	✓	✓	✓
B	✓	✓	✓	✓
C				✓

Application of the substantially all threshold

Because this transaction involves acreage blocks with PDP, PUD and probable properties, Upstream Co. must identify all single identifiable assets. Upstream Co. concludes that for acreage blocks with PDPs there are tangible assets (mineral rights and well equipment) that cannot be used separately without incurring significant cost or significant diminution in the utility or fair value of either asset. All PUD and probable properties are considered separate properties by block. Therefore, the set contains seven single identifiable assets as described below:

Block	**Well Equipment**	**PDP**	**PUD**	**Probable**
A	A1	A1	A2	A3
B	B1	B1	B2	B3
C				C1

For Block A, Upstream Co. first evaluates whether the PDP property has significantly different risk characteristics compared to the PUD property. The PDP and PUD properties are both proved properties and are in the same major asset class. The PUD property is in the final stages of development and is in the same geological formation as the PDP property. As a result, Upstream Co. concludes that the PUD property does not have significantly different risks characteristics compared to the PDP property.

Next, Upstream Co. evaluates whether the probable property in Block A has significantly different risk characteristics from the proved properties. Upstream Co. determines that the probable property has the same likelihood of successfully extracting hydrocarbons as the proved properties. That is, the only reason the probable property is not classified as a PUD property is because management has not reached a final investment decision to develop the property within five years. In addition, the risk of dry holes in this formation is not significant. Because the probable property and the proved properties are in the same major asset class, in the same geological formation and subject to low development risk, Upstream Co. concludes that the PDP property, PUD property and probable property are similar because they do not have significantly different risk characteristics. Therefore, Block A consists of one group of similar assets.

Upstream Co. then evaluates Block B and concludes that each property represents a single identifiable asset. Upstream Co. concludes that the PDP and PUD properties are similar for the same reasons as described for Block A.

Upstream Co. then evaluates whether the probable property has significantly different risk characteristics than the proved properties. Because of the high rate of dry holes in the formation for the probable property, there is significantly greater risk associated with extracting hydrocarbons from this property. As a result, Upstream Co. concludes that Block B has two groups of similar assets: (1) the PDP and PUD properties and (2) the probable property.

Upstream Co. then evaluates Block A and the proved properties in Block B and concludes that they are not similar because, while they are in the same major asset class, they have significantly different risk characteristics because the nature and location of the properties are different. For example, they are in different geological formations and are subject to different development risks.

Finally, Upstream Co. evaluates the two probable groups of similar assets (B3 and C1) and concludes that they are similar. This is because they are in the same major asset class and have similar risk characteristics (i.e., they are in the same geological formation and reserve category, hence, the likelihood of successfully extracting hydrocarbons is the same and the development risk is the same). Therefore, the groups can be combined as a similar asset.

As a result, the set contains three groups of similar assets:

Block	Well equipment	PDP	PUD	Probable
A	A1	A1	A2	A3
B	B1	B1	B2	B3
C				C1

Upstream 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 assets. Upstream Co. must then evaluate whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs.

In this example, Upstream Co. performs each step of the process to determine whether the substantially all threshold is not met for illustrative purposes. However, once an entity either quantitatively or qualitatively determines that the substantially all threshold is not met it would then determine whether an input and substantive process exist.

Determination of whether an input and substantive process exist

Because two of the three groups of similar assets include producing properties, Upstream Co. concludes that the set is generating outputs. Therefore, it evaluates whether the set includes an input and substantive process by applying the guidance for sets generating outputs.

Upstream Co. determines that the set includes inputs (the properties, which include well equipment) as well as substantive processes. The equipment associated with the PDPs, while an input, also performs an automated process that significantly contributes to the production of outputs and cannot be replaced without significant cost, effort and delay in the ability to continue producing outputs. Therefore, the set is a business.

Considerations for midstream oil and gas transactions

This section describes considerations for entities applying the guidance to midstream oil and gas transactions but doesn't repeat the guidance on the definition of a business.

Nature of midstream oil and gas transactions

Midstream oil and gas entities often engage in gathering, processing, storing and transporting oil and gas. Midstream oil and gas transactions may include the transfer of any one (or a combination) of the following:

- Gathering or transportation assets such as pipelines
- Processing equipment and/or facilities
- Storage tanks
- Land easements that provide the right to access assets
- Supervisory control and data acquisition (SCADA) systems
- In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities (i.e., an off-market component)

Applying the substantially all threshold

Midstream oil and gas entities must determine whether transferred assets that wouldn't be a single identifiable asset in a business combination should be combined into a single identifiable asset to apply the substantially all threshold. Each midstream arrangement will require careful evaluation of the facts and circumstances of the contract to identify the assets acquired.

If a midstream oil and gas transaction involves the transfer of a land easement, a midstream entity must evaluate whether the land easement is a lease by following the guidance in ASC 842 after it adopts ASU 2016-02 or following other US GAAP for the right to use land. However, this determination generally would not affect an entity's ability to combine a recognized land easement (i.e., a lease asset or intangible asset) with a tangible asset (e.g., pipeline, gathering system) as a single identifiable asset because the tangible asset cannot be separated from the land easement without incurring significant cost or diminution in the utility or fair value of either asset.

Illustration 8 — Evaluating single identifiable assets in a midstream transaction

Midstream Co. drops down or transfers an integrated set of assets to MLP, a consolidated master limited partnership of Midstream Co. The integrated set of assets includes a pipeline, SCADA system and land easement.

Application of the substantially all threshold

MLP concludes that the pipeline and SCADA system can be considered a single identifiable asset because they are attached and cannot be separated from one another without significant cost or diminution in the utility or the fair value of either asset. Additionally, MLP determines that the land easement is an intangible asset. The pipeline and SCADA system are attached to the land easement and cannot be removed without incurring significant cost and diminution in the utility or the fair value of either asset. Therefore, MLP concludes that the pipeline, SCADA system and land easement should be combined and considered a single identifiable asset, solely for the purpose of evaluating the threshold.

MLP concludes that substantially all of the fair value of the gross assets acquired is concentrated in the pipeline set. Therefore, the acquired set is not a business.

Midstream entities must apply judgment when determining which arrangements are part of the transferred set.

Determining what is part of the set

To apply the definition of a business, an entity must determine which elements are part of the set and which are part of a separate transaction.

For example, in conjunction with an acquisition, midstream entities often enter into contractual agreements with the seller of the acquired set to provide services to the seller using the set, which the seller uses together with other assets it owns to fulfill contracts with customers. Additionally, midstream entities may enter into agreements with the seller in which the seller provides certain business services to the midstream entity (e.g., human resources, accounting). The acquirer would have to evaluate whether any new arrangement is an element of the acquired set. Any inputs or processes provided through separate transactions are excluded from the threshold evaluation and the analysis of whether the set meets the definition of a business. That is, an entity needs to evaluate what is in the set before it evaluates whether that set is a business. Refer to section 3.4.1.2 of our Financial reporting developments (FRD) publication, *Business combinations*, for further information on evaluating what is part of the set.

How we see it

Midstream entities will need to carefully evaluate the substance and timing of any service arrangements to determine whether the arrangements are part of the transferred set or are entered into as a separate transaction and therefore not included in the set.

Determining whether inputs and a substantive process exist

When the set is generating outputs

Midstream transactions typically involve the transfer of SCADA systems that consist of physical equipment, including pumps, meters and other assets used to facilitate gathering, processing, storing and transporting oil and gas. We believe SCADA systems serve as a substantive process because they significantly contribute to the ability to continue producing outputs and cannot be replaced without significant cost, effort or delay in the ability to continue producing outputs.

Effect of the definition of a business on other US GAAP

Other areas of US GAAP that depend on the definition of a business in ASC 805 include the following:

- An entity that meets the definition of a business under ASC 805 is not subject to the guidance on variable interest entities in ASC 810 when certain other conditions listed in ASC 810-10-15-17(d) are met. See section 4.4 of our FRD, *Consolidation*, for further discussion.
- An entity deconsolidates a subsidiary or derecognizes a group of assets that meet the definition of a business under ASC 805 if it loses control of that subsidiary or group of assets, as required by ASC 810-10-40-3A. See section 19.1 of our FRD, *Consolidation*, for further discussion.
- A component of an operating segment is a reporting unit (as defined in ASC 350[9]) if, among other things, the component meets the definition of a business under ASC 805. See section 3.8 of our FRD, *Intangibles — Goodwill and other*, for further discussion.
- When a portion of a reporting unit that meets the definition of a business under ASC 805 is disposed of, some of the goodwill of the reporting unit should be assigned to the portion of the reporting unit being disposed. See section 3.14 of our FRD, *Intangibles — Goodwill and other*, for further discussion.

How we see it

Entities may need to evaluate whether goodwill is impaired if they dispose of a portion of a reporting unit and that portion does not meet the definition of a business under the new guidance. Because no goodwill would be assigned to the group of assets the entity sold, the remaining goodwill may be impaired since it will no longer be supported by the cash flows of the group of assets disposed of.

Additional considerations

Definition of a business under SEC rules and regulations

The guidance in ASU 2017-01 does not change how the Securities and Exchange Commission (SEC) defines a business in Article 11-01(d) of Regulation S-X (Article 11). A registrant must continue to evaluate the definition of a business under Article 11 to determine whether it is required to provide financial statements of an acquired business under Rule 3-05 of Regulation S-X (Rule 3-05). Furthermore, in SEC Staff Accounting Bulletin No. 47, Financial Statements of Oil and Gas Producers; Exchange Offers (Topic 2.D), the SEC staff indicated that a working interest in an oil and gas property is considered to be a business under Rule 3-05.

Applying the definition of a business may result in more acquisitions not meeting the definition of a business under US GAAP but meeting the SEC's definition of a business. Refer to our SEC Financial Reporting Series publication, *Pro forma financial information: A guide for applying Article 11 of Regulation S-X*, for guidance on the SEC's definition of a business.

Endnotes:

[1] ASU 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business,* codified in ASC 805

[2] ASC 805, *Business Combinations*.

[3] ASC 805-20-55-37 defines mineral rights as tangible assets for financial reporting purposes.

[4] ASC 932, *Extractive Activities — Oil and Gas*.

[5] ASC 932-235-50-13 and ASC 932-360-25-4.

[6] Rule 4-10(a)(31)(ii) of Regulation S-X requires that undrilled locations can be classified as having proved undeveloped reserves only if the development plan has been adopted and indicates that the undrilled locations are scheduled to be drilled within five years, unless the specific circumstances justify a longer time.

[7] ASC 805-10-55-4(c).

[8] Paragraph BC51 of ASU 2017-01.

[9] ASC 350, *Intangibles — Goodwill and Other*.

Appendix: Summary of key differences between accounting for business combinations and asset acquisitions

Asset acquisitions (except for the initial consolidation of a variable interest entity by a primary beneficiary) are accounted for by allocating the cost of the acquisition to the individual assets acquired and liabilities assumed on a relative fair value basis. In a business combination, by contrast, the acquired assets and assumed liabilities, including any previously existing ownership interests and noncontrolling interests, are measured at fair value (with limited exceptions). That is, the business combination model is a "new basis" approach, while the asset acquisition model is a "cost accumulation" approach. The following table summarizes the key differences:

Item	Business combination	Asset acquisition
Transaction costs	Transaction costs are expensed as incurred.	Transaction costs are capitalized as a component of the cost of the assets acquired.
IPR&D assets	IPR&D is capitalized as an indefinite-lived intangible asset, regardless of whether the IPR&D asset has an alternative future use.	IPR&D is expensed unless the IPR&D has an alternative future use.
Measurement period	An acquirer has up to one year to obtain information about the facts and circumstances that existed as of the acquisition date and adjust any provisional amounts recognized.	There is no measurement period.
Measurement of nonfinancial assets	Nonfinancial assets are generally recognized at fair value if the recognition criteria in ASC 805-20-25-10 are met.	Nonfinancial assets are recognized in accordance with other applicable US GAAP (e.g., ASC 350). Any excess consideration transferred over the fair value of the nonfinancial assets is allocated to these assets based on the ASC 350 relative fair value requirement.
Goodwill	Goodwill only arises in a business combination.	Goodwill is not recognized in an asset acquisition. Any excess consideration transferred over the fair value of the net assets acquired is allocated on a relative fair value basis to the identifiable net assets other than "non-qualifying" assets.
Consideration transferred is less than the fair value of the net assets acquired (bargain purchases)	Bargain purchases are recognized as a gain in earnings on the acquisition date.	There is no gain recognized in earnings. The excess fair value over the consideration transferred is allocated on a relative fair value basis to the net identifiable assets acquired other than "non-qualifying" assets.
Assembled workforce	An assembled workforce isn't recognized as a separate intangible asset; instead, it is subsumed into goodwill.	An assembled workforce is recognized separately as an intangible asset.

Item	Business combination	Asset acquisition
Acquired contingencies	Preacquisition contingent assets and liabilities are recognized at the acquisition date at fair value if the acquisition-date fair value of the asset or liability can be determined during the measurement period. Otherwise, the contingent asset or liability is accounted for in accordance with ASC 450.[1]	Preacquisition contingent assets and liabilities are accounted for in accordance with ASC 450.
Deferred taxes	Deferred taxes are generally recorded on most temporary book/tax differences of assets acquired and liabilities assumed.	Because goodwill is not recognized in an asset acquisition, the measurement of deferred income tax assets acquired and liabilities assumed in an asset acquisition will usually require an iterative approach that affects the measurement of other individual assets and assumed liabilities in the net asset group. The measurement of deferred taxes on temporary differences in an asset acquisition is determined using the simultaneous equations method described in ASC 740.[2]
Leases classification	The reassessment of lease classification is not required unless the lease contract has been modified and deemed a new lease under the lease guidance.[3]	The reassessment of lease classification is generally required.
Contingent consideration	Contingent consideration is recognized at its acquisition-date fair value as part of the consideration transferred.	Contingent consideration is generally recognized when the contingency is resolved (i.e., when the contingent consideration is paid or becomes payable).

See Appendix A of our FRD, *Business combinations*, for further information on accounting for asset acquisitions.

[1] ASC 450, *Contingencies*.

[2] ASC 740, *Income Taxes*.

[3] ASC 840, *Leases*, or ASC 842, *Leases*, after adopting ASU 2016-02.