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Defining Issues®

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FASB Proposes to Clarify the Definition of a Business

Responding to stakeholder feedback, the FASB is proposing a new framework to determine whether a set of assets and activities is a business, which would narrow the current definition.[1]

Key Facts

Under the proposed Accounting Standards Update (ASU), an integrated set of activities and assets (a set) is a business if it has, at a minimum, an input and a substantive process that together contribute to the ability to create outputs. The proposal includes an initial screening test (A) that reduces the population of potential businesses before an entity analyzes whether there is an input and a substantive process in the set (B). The following is an overview.

A **Is substantially all of the fair value of the gross assets acquired concentrated in a single (group of similar) identifiable asset(s)?**

If yes, the set is not a business. If no…

B **Evaluate whether an input and a substantive process exist… Does the set have outputs?**

If yes…	**If no…**
The set is a business if it includes: • Organized workforce with skills, knowledge, or experience critical to continue producing outputs; • Process that cannot be replaced without significant cost, effort, or delay; **or** • Process that is considered unique or scarce.	The set is a business if it includes: • Organized workforce with skills, knowledge, or experience to perform an acquired process (group of processes) that, when applied to other acquired input(s), is critical to the ability to develop or convert the acquired input(s) into outputs.

Key Impact

Industries that are likely to be most affected are real estate, life sciences, and extractive, with fewer transactions being identified as acquiring or selling a business.

[1] Proposed Accounting Standards Update, Clarifying the Definition of a Business, November 23, 2015, available at www.fasb.org.

Scope Broader Than Acquisitions

Consideration of the proposal is likely to focus on the acquisition of a business.

However, the definition of a business affects many areas of accounting and financial reporting, including acquisitions and disposals, and the applicability of the variable interest entity consolidation requirements.

Why Does the Definition of a Business Matter?

Some of the differences in accounting for the acquisition of a business versus a group of assets may be significant. Examples of these differences follow.

Asset	Business
Initial Measurement	
Purchase price allocated on a relative fair value basis. No goodwill or bargain purchase gain (see below) is recognized.	Identifiable assets and liabilities generally measured at fair value. Goodwill or bargain purchase gain may be recognized.
Direct Acquisition-Related Costs	
Capitalized and included in purchase price.	Generally expensed as incurred.
Bargain Purchase Amount	
Allocated to identifiable nonfinancial assets and liabilities on a relative fair value basis.	Recognized immediately in earnings as a gain.
Contingent Consideration	
Not recognized until contingency is resolved.	Recognized at the acquisition date fair value. Subsequent changes to the fair value of liability-classified contingent consideration are recognized in earnings.
In-Process R&D	
Purchase price allocated to in-process R&D and then expensed unless it has an alternative future use.	Capitalized at fair value and accounted for as an indefinite-lived intangible asset until completion or abandonment of the project.

Examples That Illustrate the Proposal

Some Assets Could Be Grouped in Applying the Screening Test

In applying the screening test (A), a single identifiable asset generally would include any identifiable asset or group of assets that could be recognized and measured as a single identifiable asset in a business combination (e.g., complementary intangible assets that have similar useful lives).

Examples of assets that generally would not be combined include tangible and intangible assets; identifiable intangible assets in different major intangible asset classes; financial and nonfinancial assets; different major classes of financial assets; and different major classes of tangible nonfinancial assets.

Example 1: Real Estate[2]

Facts

- REIT purchases all of the outstanding shares of Building Co. from Seller.
- Building Co. holds a multi-tenant corporate office park with six 10-story office buildings leased to maximum occupancy. Seller manages its properties centrally and manages the operations of Building Co. with its own employees.
- REIT acquires the land, buildings, and in-place leases (at market), and assumes vendor contracts for outsourced cleaning and security. Seller's employees that perform leasing (e.g., sales and underwriting), tenant management, financing, and other strategic management processes are not acquired.
- REIT plans to replace the property management and employees with its own internal resources.

Analysis

A

REIT first considers whether substantially all of the fair value of the gross assets acquired is concentrated in a single (or group of similar) identifiable asset(s). Although the in-place leases are at market value, REIT concludes that their fair value is significant and that the fair value of the gross assets acquired is not concentrated in either the leases or the tangible assets.

B

The set has continuing revenues through the in-place leases, and therefore, has outputs. REIT concludes that the processes performed through the cleaning and security contracts (the only processes acquired) are considered ancillary or minor in the context of all of the processes required to create outputs in the real estate industry (i.e., leasing, tenant management, financing, and management of building operations). REIT also concludes that the cleaning and security processes could easily be replaced with little cost, effort, or delay, and are not considered unique or scarce.

Conclusion

The acquired set does not include both an input and a substantive process and, therefore, would not be considered a business.

KPMG Observations

Fewer real estate transactions would qualify as business acquisitions (as illustrated in Example 1) under the proposal than qualify today, but it may be difficult to determine whether assets are combined or considered similar in applying the screening test (A). There is limited guidance in the proposal beyond the examples, and judgment would be required.

[2] Based on Case H in the Proposed ASU.

Outputs Do Not Automatically Mean That There Is a Business

In Example 2, no revenue (outputs) is currently being generated.

However, if the acquired set does have outputs, a continuation of revenues generated from an acquired set would not, on its own, indicate that a substantive process has been acquired (see Example 1). Therefore, assumed contractual arrangements that provide for the continuation of revenues (e.g., customer contracts, customer lists, and leases when the set is the lessor), would be excluded from determining whether there is a substantive process.

In addition, the definition of outputs would be amended to align better with the new revenue standard, focusing on providing "goods or services to customers, other revenues, or investment income, such as dividends or interest…"[4]

Example 2: Life Sciences[3]

Facts

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

Analysis

A Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single (or group of similar) identifiable asset(s).

This is because the fair value of the gross assets is not concentrated but rather spread across a number of items, both tangible (the corporate headquarters, a research lab, and testing equipment) and intangible (the in-process R&D projects plus the acquired workforce). These assets are not similar for the purpose of applying the screening test.

B Pharma Co. concludes that 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 R&D inputs, are critical to the ability to develop those inputs into outputs.

Conclusion

The set includes both inputs and substantive processes and would be a business.

KPMG Observations

The proposal includes a number of examples to help constituents understand how the FASB intends its framework to be applied. The examples cover a variety of industries and transactions not covered in this *Defining Issues*, including oil and gas, manufacturing, and the acquisition of intellectual property and single-family homes.

[3] Based on Case E in the Proposed ASU.

[4] FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, available at www.fasb.org.

Proposed Transition and Effective Date

An entity would apply the proposal prospectively to transactions that occur on or after the effective date. The Board will determine the effective date and consider whether to permit early adoption after it receives stakeholder feedback. No disclosures would be required at transition.

Convergence

The proposal would create a new difference between U.S. GAAP and IFRS because the current definition of a business under U.S. GAAP is converged with the IFRS definition. However, stakeholder feedback obtained by the FASB indicated that the definitions are applied differently under U.S. GAAP and IFRS, with the definition being applied more broadly under U.S. GAAP.

KPMG Observations

The IASB's recent post-implementation review of its standard on business combinations revealed stakeholder concerns about the challenges in applying the definition of a business.[5]

In October 2015, the IASB discussed the definition of a business and tentatively decided to propose changes to IFRS 3 that are the same as the amendments proposed by the FASB. In November 2015, the IFRS Interpretations Committee confirmed that issuing an amendment similar to the FASB's proposal would help resolve practical problems under IFRS.

Next Steps

Comments on the proposed ASU are due by January 22, 2016. The FASB will review the comments and determine whether to finalize the ASU as proposed.

The FASB's project to clarify the definition of a business includes two additional phases that remain under discussion, with no time frame for issuing exposure drafts. The first phase relates to partial sales or transfers of, and the corresponding acquisition of partial interests in, a nonfinancial asset or assets. The second phase relates to aligning the recognition and measurement guidance for assets versus businesses.

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[5] Post-implementation Review of IFRS 3 Business Combinations – Report and Feedback Statement, available at www.ifrs.org.