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The FASB's new definition of a business

A comprehensive look at the new definition and its impact

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At a glance

On January 5, 2017, the FASB issued Accounting Standards Update 2017-01, which revises the definition of a business.

The changes to the definition of a business will likely result in more acquisitions being accounted for as asset acquisitions across most industries, particularly real estate and pharmaceuticals. The definition of a business also affects many other areas of accounting including disposals, consolidation, and segment changes.

Background

.1 Under the current business combinations guidance, there are three elements of a business: inputs, processes, and outputs. Outputs are not required to be present to meet the definition of a business. An entity needs to evaluate whether the set of assets and activities (a "set") is capable of being managed as a business by a market participant. If a set in a transaction does not include all of the inputs and processes that a seller used in operating that set, it can still qualify as a business as long as a market participant can replace the missing inputs and processes. While evaluating a transaction in this way aids in reaching consistent conclusions as to whether a business or a group of assets was acquired, this evaluation may result in transactions qualifying as business combinations when they are more akin to purchases of assets. Furthermore, the guidance does not specify the *minimum* inputs and processes required for a set to meet the definition of a business, which has added to its broad application. The FASB's revised definition of a business will result in fewer transactions qualifying as business combinations.

.2 The determination of whether a set is a business or a group of assets will impact the accounting for transactions related to that set. In a business combination, assets and liabilities acquired are generally recorded at fair value and goodwill is recognized for any excess consideration. In addition, in-process research and development and assumed contingencies are typically recognized and measured at fair value. Transaction costs are expensed and not included as part of the acquisition cost. In an asset acquisition, goodwill is not recognized, in-process research and development is expensed at the acquisition date if there is no alternative use, contingencies assumed are recorded only if probable, and transaction costs are generally capitalized.

.3 Another key difference is that there is a period of time, referred to as the measurement period, in which an entity can finalize the accounting for provisional amounts recorded in a business combination. The concept of a measurement period does not exist for asset acquisitions.

.4 While the definition of a business is written in the context of acquisitions, it also impacts the accounting in other areas, such as the accounting for dispositions, segment changes, and common control reorganizations, the determination and reassessment of distinct and separable operations for foreign currency transactions, lease classification upon an acquisition, and the assessment of variable interest entities.

.5 The FASB's updated definition does not impact the SEC's definition of a business, which is used to determine whether historical financial statements and pro forma information is required in certain SEC filings.

Key provisions

.6 The FASB's new framework will assist entities in evaluating whether a set should be accounted for as an acquisition of a business or a group of assets. It adds an initial screen to determine if substantially all of the fair value of the gross assets acquired is concentrated in a single asset or group of similar assets. If that screen is met, the set is not a business. The new framework also specifies the minimum required inputs and processes necessary to be a business. It removes the need to consider a market participant's ability to replace missing elements when all of the inputs or processes that the seller used in operating a business were not obtained.

.7 What qualifies as an input and process remains substantially the same as in the current guidance. While processes would typically be documented, the guidance clarifies that the intellectual capacity of an organized workforce could also qualify as a process. Administrative systems (e.g., billing, payroll) are typically not considered processes that significantly contribute to the creation of outputs.

.8 The new guidance narrows the definition of "outputs" to be consistent with how it is described in ASC 606, *Revenue from Contracts with Customers*. As a result, fewer sets will be considered to have outputs.

Screen test

.9 The guidance includes a new screen that directs the entity to determine whether substantially all of the fair value of the gross assets acquired is concentrated in a single asset or group of similar assets. If so, the set is not considered a business.

PwC observation:

The standard does not define what constitutes "substantially all." However, this term is used in other areas of GAAP (e.g., revenue, leases) and, while not necessarily a bright line, is typically interpreted to mean approximately 90%.

.10 Regardless of whether a set is a business or a group of assets, a reporting entity must determine the fair value of each asset acquired in order to allocate the consideration. As such, the new screen is not expected to add additional cost or complexity when evaluating an acquisition. However, the Board acknowledged that there could be additional costs to perform a quantitative analysis for a disposition.

.11 The initial screen may be performed qualitatively. The guidance includes an example of an acquisition of a license for a drug candidate and an at-market service contract. The at-market contract is qualitatively determined to have little or no fair value while, based on the significance of the license, it is clear that the threshold is met. In contrast, if a set includes multiple licenses for dissimilar drug candidates, and each has more than an insignificant fair value, the entity could qualitatively determine that the threshold is not met.

PwC observation:

If an entity does not apply the screen, but first evaluates a set under the more detailed framework, the screen may still need to be considered. If the framework indicates that the set is not a business, an entity need not evaluate the screen. However, when the framework indicates that the acquired set is a business, an entity should be comfortable that the acquired set would not meet the threshold to be considered an asset acquisition. An entity can evaluate the set in the most cost-effective manner.

Gross Assets

.12 For the purpose of the screen, there are several reasons why the fair value of the gross assets acquired is not necessarily the same as the consideration paid. For example, the denominator will exclude any liabilities assumed.

.13 Gross assets will also differ from consideration paid in a partial acquisition (i.e., it is impacted when there are noncontrolling interests and previously held interests). When a transaction results in control of a legal entity being obtained, even if less than 100% of the entity is acquired, total gross assets should be used in the screen. For example, 100% of the gross assets would be used as the denominator in the screen even though only a 60% controlling interest in the entity was acquired.

.14 In addition, gross assets should exclude cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. The Board noted that the tax form of the transaction and whether cash and cash equivalents were included should not affect the determination of whether the set is a business.

.15 Finally, the fair value of gross assets includes any consideration transferred in excess of the fair value of the net assets acquired (i.e., what would otherwise be recorded as goodwill in a business combination).

Single Asset

.16 The screen applies to a single asset or group of similar assets. A single asset includes any individual asset or group of assets that could be recognized and measured as a single asset under the business combination guidance (ASC 805). For example, ASC 805 allows certain complementary intangible assets with similar useful lives to be grouped as a single asset.

.17 The new guidance provides two scenarios in which separately recorded assets must be grouped into a single asset for the purpose of the screen.

- A tangible asset that is attached to another tangible asset should be considered a single asset. This includes an intangible asset representing the right to use a tangible asset (e.g., a building with an associated ground lease). To be considered attached, assets cannot be physically removed and used separately without incurring significant costs. For example, land and a building would generally be recognized as separate assets in a business combination, but would be considered a single asset when performing the screen.

- In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets should be considered a single asset (e.g., a building and an associated in-place lease intangible).

Similar Assets

.18 The screen can also be met if the fair value of the set is concentrated in a group of similar assets. Entities should consider the nature of the assets and the risks associated with managing and creating outputs when determining if assets are similar. If the risks are not similar, the assets cannot be combined for the screen. The Board indicated that when the risks in managing and creating outputs are dissimilar, the substantive processes required to manage and create outputs might need to be more advanced. As such, the determination of whether the acquired set constitutes a business should be made using the framework rather than the screen.

PwC observation:

Identifying similar assets based on the nature of the assets and their risk characteristics is an area that will require significant judgment. The guidance includes examples to illustrate how to make this evaluation.

.19 The following should not be considered similar assets for the purpose of performing the screen:
- A tangible asset and separate intangible asset
- Intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, in-process research and development)
- A financial asset and a nonfinancial asset
- Different major classes of financial assets (for example, accounts receivable and investments)
- Different major classes of tangible assets (for example, inventory and fixed assets)
- Assets within the same major asset class that have significantly different risk characteristics (for example, real estate investments that consist of residential and commercial properties)

The framework

.20 Under the new definition, to be considered a business, a set needs to have an input and a substantive process that together *significantly* contribute to the ability to create outputs. The guidance provides a framework to evaluate when an input and a substantive process are present (including for early stage companies that have not generated outputs). The guidance includes more stringent criteria for sets without outputs to be considered businesses.

PwC observation:

The Board eliminated the requirement to evaluate whether a market participant could replace any missing inputs or processes in determining whether or not a set qualifies as a business. However, the new guidance retains the requirement to evaluate whether the set is capable of being managed as a business by a market participant. Therefore, it is not relevant whether the seller previously operated the set as a business or whether the acquirer intends to operate the set as a business. The Board wanted to retain the requirement to evaluate the set from a market participant's perspective to prevent similar transactions from being accounted for differently depending on the buyer's intent.

.21 Even though individual processes that are used to create outputs may be insignificant on their own, entities should consider if they could be substantive in the aggregate.

.22 An organized workforce could be an input, a process, or both. For example, a consulting firm might only include employees (inputs) that utilize their intellectual capacity (a process) to generate outputs.

PwC observation:

While the guidance does not include a formal definition of an employee, we believe it would be reasonable to use the definition of an employee included in the FASB guidance on stock compensation (ASC 718). Therefore, an employee would be someone who will have an employer-employee relationship with the acquirer based on common law as a result of the acquisition.

The framework - outputs are not present

.23 When a set does not have outputs, in order to demonstrate an input and substantive process that together significantly contribute to the ability to create outputs, the set will need to include (1) employees that form an organized workforce and (2) an input that the workforce could develop or convert into outputs. When a set does not have outputs, the workforce needs to be actively contributing to the development of outputs. This is because without employees, there are inherent limitations on the processes that can be performed to create outputs.

.24 An organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process that when applied to another input, is critical to the ability to develop or convert the acquired input into outputs. Depending on the nature of the process, the acquired workforce necessary to satisfy these requirements may consist of a small number of people (e.g., scientists working on a research and development project).

.25 Inputs that employees who form an organized workforce could develop or convert into outputs could include intellectual property that could be used to develop a good or service, resources that could be developed to create outputs, and access to necessary materials or rights that enable the creation of future outputs.

> **PwC observation:**
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> Judgment will be required to determine whether the process performed by the organized workforce is critical to the ability to convert another acquired input into outputs. To make this judgment, the likelihood of producing an output if the acquired process was not present should be evaluated. If it is unlikely that the output would be created without the process, the process is likely critical to the ability to convert an input into outputs.

The framework - outputs are present

.26 A set will have outputs when there is a continuation of revenue before and after the transaction. However, the continuation of revenues does not on its own indicate that both an input and a substantive process have been acquired. When determining whether a process has been acquired, the presence of contractual arrangements that provide for the continuation of revenues, such as customer contracts, customer lists, and leases, would not be indicative of an acquired process and should be excluded from the analysis.

.27 The guidance includes the following examples of substantive processes, which when applied to an acquired input, significantly contribute to the ability to create outputs:

- Employees that form an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process that is critical to continue producing outputs. A process 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.
- An acquired contract that provides access to an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process that is critical to continue producing outputs
- The acquired process cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs
- The acquired process is considered unique or scarce

.28 The guidance includes examples of how to evaluate the set when outputs are present. In one example, a distributor acquires (1) distribution rights for a particular yogurt brand, (2) existing customer contracts, and (3) an at-market supply contract with the producer of the yogurt, but does not acquire any employees. In this example, the acquirer first determines that the set does not meet the the screen as the fair value will be assigned to multiple dissimilar assets (the license and the customer contracts). Since the set includes outputs through the continuation of revenues with customers, the acquirer evaluates the examples listed in paragraph .27 and determines that the set is not a business because it does not include an organized workforce and there were no acquired processes. Although it is likely that economic goodwill exists in this example as a result of revenue derived from future customers, this goodwill will be subsumed in the assets acquired.

> **PwC observation:**
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> This example illustrates how the new guidance may result in a change in how entities evaluate transactions. Under current GAAP, entities might look to the in-place customer contracts that provide for the continuation of revenues and determine that the set includes both an input and a process (e.g., the distribution rights as an input and contractual provisions requiring minimum future delivery requirements as a process). Under the new framework, the existence of customer contracts are not part of the analysis of whether a substantive process has been acquired.

.29 It is not uncommon for various processes to be performed by third parties through contractual arrangements (e.g., asset managers). However, just because the set includes access to an organized workforce does not necessarily mean that the workforce is substantive. Similar to the framework for when outputs are not present, an entity will need to consider if the organized workforce accessed through a contractual arrangement is critical to continue producing outputs. For instance, an entity should consider the duration and renewal terms of a contract.

PwC observation:

An organized workforce can be an indicator of a substantive process. However, when outputs are present, an organized workforce is not required for the set to be considered a business. A substantive process can exist without an organized workforce (e.g., if the set includes an automated process through acquired technology or infrastructure).

The presence of more than an insignificant amount of goodwill

.30 When evaluating a set under the framework, the presence of more than an insignificant amount of goodwill may indicate that the acquired process is substantive. That is, if an entity is willing to pay an amount above fair value of the net assets included in the set, that may indicate that the set includes a substantive process. However, there could be scenarios (as in the yogurt distribution example above) in which there is economic goodwill but the set would not be a business unless an input and a substantive process are identified.

What's next

.31 For public business entities, the guidance is effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. Prospective application is required.

.32 The amendments can be early adopted and applied to transactions occurring before the guidance was issued (January 5, 2017) as long as the applicable financial statements have not been issued. For example, a public company with a calendar year-end can apply the guidance to transactions that occurred after its third quarter, but before the filing of its 2016 Form 10-K. If early adopted, the amendments must be applied to all transactions affected by the definition of a business (e.g., movements of a set between operating segments should be assessed to determine if the set meets the definition of a business, which could affect the allocation of goodwill).

.33 The guidance is the first phase of a broader project. The second phase, expected to be finalized in early 2017, will clarify the guidance for the derecognition of nonfinancial assets, including partial sales and transfers. As we expect fewer sets will qualify as a business under the new definition, the importance of the second phase of the project will be heightened as more sets will be assets and thus derecognized through the nonfinancial asset guidance. In the third phase, the FASB may revisit the accounting differences between asset and business acquisitions and disposals.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement team. Engagement teams who have questions should contact the National Professional Services Group.

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