FASB Updates ‘Business’ Definition

On January 5, 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business*. This definition is significant because it determines what accounting model to use on an acquisition and disposal of a business or group of assets. The new standard makes several changes that narrow the current definition. The appendix includes examples from the ASU specific to real estate, banking and manufacturing in the new model’s application.

These changes are the first piece of a broader project. The second phase will address the accounting for partial sales of real estate. Current guidance in Subtopic 360-20, *Property, Plant, and Equipment—Real Estate Sales,* is being superseded by the new revenue recognition standard (ASU 2014-09), leaving a gap in accounting guidance. FASB is expected to issue a final standard in the first quarter of 2017 addressing the accounting for partial sales of real estate. The third phase will focus on alignment of measurement and recognition guidance for assets versus businesses.

The U.S. Securities and Exchange Commission’s (SEC) definition of a business, used to determine whether historical financial statements and pro forma information is required for certain SEC filings, remains unchanged.

Background

Economically, there is little difference between purchasing—or selling—an asset versus a business, but there is a substantial difference in the accounting, as noted in the following table. The current definition of a business is very broad and seen by financial statement preparers as difficult and costly to apply. The definition is especially challenging for the pharmaceutical, real estate and extractive industries (oil, gas and mining).

Accounting Outcomes	
Contingent Consideration	
Asset Acquisition	Business Combination
Not recognized until the contingency is resolved	Recognized at the acquisition date fair value while changes in estimates are trued-up through earnings after the acquisition date
In-Process Research & Development	
Asset Acquisition	Business Combination
Expensed as incurred 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 (expensed as incurred after the acquisition date)
Acquisition-Related Costs	
Asset Acquisition	Business Combination
Capitalized	Expensed
Initial Measurement	
Asset Acquisition	Business Combination
Allocated cost on a relative fair value basis	Measured at fair value

Goodwill	
Asset Acquisition	Business Combination
Not applicable	Recognize as an asset and annually reassess
Intangible Asset/Liability	
Asset Acquisition	Business Combination
Recognized in accordance with Accounting Standards Codification (ASC) 350	Recognized at fair value if they meet the identifiable criteria
Bargain Purchase Price	
Asset Acquisition	Business Combination
Not applicable	Immediately recognize in earnings as a gain
Lease Classification	
Asset Acquisition	Business Combination
Classification of a lease contract should be reassessed by the new lessee	Classification of a lease contract as an operating or capital lease is based on the contractual terms at the contract's inception, unless the contract has been significantly modified

For real estate entities, current generally accepted accounting principles (GAAP) are inconsistent. Commercial property acquisitions are generally business combinations, but dispositions are treated as sales of real estate assets, as noted in the table below:

Real Estate	
Sales of Real Estate	Acquisitions of Real Estate
ASC 360-20, Real Estate Sales – Continuing Involvement model	ASC 805, Business Combinations – Control model

New Definition

ASU 2017-01 is applicable to all entities that must determine whether they have acquired or sold a business. FASB has retained much of the existing terminology but has provided greater specificity on minimum requirements to meet the definition of a business. The ASU establishes a minimum requirement that, for a set to be a business, an input and substantive process must be included that together significantly contribute to the ability to create outputs.

Business Definition	
Current	ASU 2017-01
Requires inputs and processes	Requires an input and one or more **substantive** process(es)
Evaluation of whether a market participant could replace missing elements	Eliminated
Outputs broadly defined as ability to provide a return (dividends, lower costs or other economic benefit)	Outputs defined as goods or services provided to customers, other revenues or investment income
Does not matter if all value is assigned to a **single** asset	Single or **similar assets** threshold

Under the current definition of a business, the acquisition of a building with an existing retail lease would likely be considered a business even if no employees, marketing, maintenance or other processes are obtained. In this case, the acquisition would be considered a business since inputs—land, building and lease—and outputs—lease revenue—are acquired. The missing processes in the acquisition would not affect the analysis because that element can readily be replaced by a market participant. Under the new guidance, this situation would likely be considered an asset acquisition.

Threshold

The ASU reintroduces a threshold to evaluate when a set is not a business[1]. The threshold is intended to reduce the number of transactions evaluated under the new framework. If the threshold is not met, further assessment is necessary to determine whether a set is a business.

If substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not considered a business.

"Substantially all" is not defined in this standard but is generally understood to be a high threshold, at least 90 percent. Judgment will be required as this is not a bright-line test.

An entity would compare the concentration of fair value in a single asset or group of similar assets with the gross assets acquired rather than the total consideration paid or net assets. Gross assets acquired should exclude cash and cash equivalents, deferred tax assets and goodwill resulting from the effects of deferred tax liabilities. The gross assets acquired should 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 net identifiable assets acquired. The existence of debt, *e.g.*, a building with a mortgage, or other liabilities would not skew the analysis of whether the threshold has been met.

[1] The business definition in Issue 98-3 allowed for a transferred set of activities to be an asset if all but a de minimis amount—set at 3 percent—of the fair value was represented by a single tangible or identifiable intangible asset. This was not carried forward into Statement 141(R); the current definition lacks the de minimis exception.

This assessment may be qualitative or quantitative. If a set is not a business, an entity can document its conclusion in the most cost-effective manner depending on its situation. Under the new guidance, FASB acknowledges that for dispositions the threshold may result in incremental costs when a quantitative analysis is necessary.

Single Identifiable Asset

A single identifiable asset includes any individual asset or group of assets that could be recognized and measured as a single identifiable asset in a business combination (ASC 805). These provisions allow certain complementary intangible assets with similar useful lives to be grouped as a single asset, *e.g.*, for example a copyright-protected intangible asset and related assignments or license agreements. In addition, the ASU considers these to be a single asset for the threshold analysis:

- A tangible asset that is attached to and cannot be physically removed and separately used from another tangible asset—or an intangible asset representing the right to use a tangible asset—without incurring significant cost or diminution in utility or fair value to either asset, *e.g.*, land and building
- In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets, *e.g.*, pipeline and usage rights

Similar Assets

Multiple versions of substantially the same asset type are not disqualified from being considered assets for the threshold evaluation. Entities should consider the nature of the assets and the risks associated with managing and creating outputs from the assets. These items are prohibited from being combined:

- Tangible and intangible assets
- Identifiable intangible assets in different major intangible asset classes, *e.g.*, customer-related intangibles, trademarks and in-process research and development
- Financial and nonfinancial assets
- Different major classes of financial assets, *e.g.*, cash, accounts receivable and marketable securities
- Different major classes of tangible nonfinancial assets, *e.g.*, inventory, manufacturing equipment and automobiles
- Identifiable assets within the same major asset class that have significantly different risk characteristics. The risks to be evaluated should be linked to the risks associated with the management of the assets and creation of outputs. For example, a real estate investment trust that acquires a group of assets in various stages of development—under construction, vacant or operating—would not be forced to combine these assets if the daily operations and risk management of these property types were significantly different.

Significant judgment will be required to determine what assets can be combined and considered a single asset.

Substantive Processes

A business must include at a minimum, an input and substantive process. The ASU includes a framework to determine whether a transferred set includes a substantive process. There is a separate assessment for transactions having outputs and those that do not. The criterion is more stringent when there is no current output.

Administrative duties, e.g., billing and payroll, are generally not considered 'significant' processes.

No Outputs

Entities with no outputs, *e.g.*, early-stage companies, must include an organized workforce that has the necessary skills, knowledge or experience to perform a process critical to the ability to develop or convert inputs into outputs. In assessing whether an acquired workforce is performing a substantive process, an entity should consider:

- A process is not critical if, for example, it is considered ancillary or minor in the context of all processes required to create outputs
- Inputs the organized workforce could develop—or are developing—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
    - Access to necessary materials or rights that enable the creation of future outputs

Examples of inputs that could be developed include technology, mineral interests, real estate and in-process research and development.

Current Outputs

When there is a continuation of revenue before and after the transaction, a set would have both an input and substantive process when *any* of these criteria are present:

- An organized workforce that has the necessary skills, knowledge or experience to perform a process on inputs critical to continued production; a process is not critical if it is ancillary or minor in the context of all processes required to continue producing outputs
- An acquired contract that provides access to an organized workforce with the necessary skills, knowledge or experience to perform a **critical** process for continued production
- The acquired process—when applied to inputs—**significantly** contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort or delay in continued production
- The acquired process—when applied to inputs—**significantly** contributes to the ability to continue producing outputs and is considered unique or scarce

Current practice varies on whether leases, customer contracts or other contractual revenue arrangements that result in the continuation of revenues are, in and of themselves, processes. Because contractual arrangements can significantly vary—rather than stating that such arrangements are not a process—FASB specifically excluded assumed contractual revenue arrangements from the analysis of whether a substantive process has been acquired. FASB does not believe a set should be a business just because there is a contract that provides a continuing revenue stream.

Determining whether an organized workforce is performing a critical process requires judgment and will vary by transaction and industry. An entity should evaluate whether the process is critical in the context of all processes required to create outputs, and if that process is considered ancillary or minor in that context, it is not critical.

Goodwill Indicator

In assessing if a set has both an input and substantive process, the presence of more than an insignificant amount of goodwill may indicate that the acquired process is substantive and, therefore, the acquired set is a business. However, a business need not have goodwill. FASB does not intend for consideration of goodwill to create an additional step in the analysis.

Outputs

GAAP's current output definition refers to the ability to provide a return in the form of dividends, lower costs or other economic benefits. This definition leads to a broad interpretation that does not appropriately distinguish between an asset and a business, as many transactions can provide a return, *e.g.*, the acquisition of a new machine could be expected to lower costs. The ASU narrows the definition of outputs by focusing the ability to generate goods or services provided to customers, investment income—interest or dividends—or other revenues.

Transition

These amendments should be prospectively applied on or after the effective date. No disclosures are required at transition.

Effective Date

Public business entities should apply these amendments to annual periods beginning after December 15, 2017, including interim periods within those periods. All other entities should apply the amendments to annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019.

Early Adoption

Early application is permitted for transactions occurring before the amendment's issuance or effective date, but only if the transaction has not been reported in financial statements that have been issued or made available for issuance. Transactions to be considered for early adoption include acquisitions, derecognition of a group of assets or deconsolidation of a subsidiary.

Early adoption of ASU 2017-01 is not dependent on the early adoption of the forthcoming standard on partial sales of nonfinancial assets.

Conclusion

These changes are expected to reduce the number of transactions that must be accounted for as a business combination in Topic 805. Transactions that are no longer in Topic 805's scope will not be accounted for under the acquisition method; instead, they will be accounted for as asset acquisitions, which might involve complex valuations to support purchase price allocation, especially for intangible assets that are not traded in an active market.

As noted in the first table above, asset acquisitions are accounted for at historical cost instead of fair value. In an asset acquisition, the allocated cost is based on the asset's fair value; therefore, entities will still need to determine the fair value of assets acquired when transactions cease to meet the definition of a business. In addition, for an asset acquisition including leases, the nature of the lease as a direct-financing, sales-type or operating lease is re-evaluated as of the acquisition date, whereas in a business combination the lease type is retained from the lease's inception date. The table on page 7 summarizes the appropriate accounting guidance.

In addition, the new definition's adoption may affect other areas of U.S. GAAP that use the term "business." For example, Topic 810, *Consolidations,* uses the definition of a business when determining whether relationships with a legal entity are in scope of the variable interest entity model. Entities adopting the new guidance may need to re-evaluate their conclusions.

Applicable Accounting Standards	
Valuation	U.S. GAAP Accounting Standard
Acquisition accounting – business combination	ASC 805
A group of assets acquired outside a business	ASC 350, ASC 805
Impairment testing of indefinite-lived intangible assets, including goodwill	ASC 350
Impairment of long-lived assets	ASC 360-10

For additional information, contact your BKD advisor.

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Appendix 1 – Acquisition of Loan Portfolio

Scenario 1

Bank A purchases a loan portfolio from Bank Z consisting of residential mortgages with terms, size and risk ratings that are not significantly different. Bank A does not take over Bank Z employees who managed the portfolio's credit risk and the relationship with borrowers such as brokers, vendors and risk managers.

Bank A first considers the threshold guidance and concludes that the nature of the assets—residential mortgage loans—is similar and the risks associated with managing and creating outputs are not significantly different because the terms, size and risk ratings of the loans are not significantly different. Because all of the fair value of the gross assets acquired is in a group of similar identifiable assets, **the set is not a business.**

Scenario 2

Assume the same facts as in Scenario 1 except that the loan portfolio consists of commercial loans with term, size and risk ratings that are significantly different.

Bank A again considers the threshold guidance. Bank A concludes that the nature of the assets—commercial loans—is similar; however, because the term, size and risk ratings of the loans are significantly different, Bank A concludes that the risks associated with managing and creating outputs are significantly different. Bank A concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and further evaluation is required.

The acquisition has current outputs, since there is a continuation of revenues (interest income). Bank A now must determine whether the set includes both inputs and a substantive process that together significantly contribute to the ability to create outputs. Because the purchase does not include an organized workforce or acquired processes, **the set is not a business.**

Scenario 3

Assume the same facts as in Scenario 2 except that Bank A takes over the Bank Z employees who managed the portfolio's credit risk and the relationship with borrowers such as brokers and risk managers. In addition, consideration transferred is significantly higher than Bank A's estimate of the loan portfolio's fair value.

Bank A considers the threshold guidance and concludes the loan portfolio does not consist of similar identifiable assets. Bank A also concludes there is significant fair value associated with different groups of financial assets and the acquired workforce. Bank A concludes that substantially all the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and further evaluation is required to conclude if the acquisition is considered a business.

The set has outputs through the continuation of revenues (interest income). Bank A now must determine whether the set includes both an input and substantive process that together significantly contribute to the ability to create outputs. Because the purchase includes an organized workforce that performs processes—customer relationship and credit risk management—critical to the ability to continue producing outputs, **the set is a business.**

Appendix 2 – Acquisition of Real Estate

Scenario 1

ABC acquires, renovates, leases, sells and manages real estate properties and has acquired a portfolio of 10 single-family homes that each have in-place leases. The only elements included in the acquired set are the 10 single-family homes and the 10 in-place leases. Each single-family home includes the land, building and property improvements. Each home has a different floor plan, square footage, lot and interior design. No employees or other assets are acquired.

ABC first considers the threshold guidance and concludes that the land, building, property improvements and in-place leases at each property can be considered a single asset. The building and property improvements are attached to the land and cannot be removed without incurring significant cost. In addition, the in-place lease is an intangible asset that should be combined with the related real estate and considered a single asset.

ABC also concludes that the 10 single assets—the combined land, building, in-place lease intangible and property improvements—are similar. Each home has a different floor plan; however, the nature of the assets—all single-family homes—is similar. ABC also concludes that the risks associated with managing and creating outputs are not significantly different; the risks associated with operating the properties and tenant acquisition and management are not significantly different because the types of homes and class of customers are not significantly different. The risks associated with operating in the real estate market of the homes acquired are not significantly different. ABC concludes that substantially all the fair value of the gross assets acquired is concentrated in the group of similar identifiable assets; thus, **the set is not a business.**

Scenario 2

Assume the same facts as in Scenario 1 except that ABC also acquires an office park with six 10-story office buildings leased to maximum occupancy, all of which have significant fair value. ABC also acquires the vendor contracts for outsourced cleaning, security and maintenance. Seller's employees that perform leasing—sales, underwriting and so forth—tenant management, financing and other strategic management processes are **not** included in the set. ABC plans to replace the property management and employees with its own internal resources.

ABC concludes the single-family homes and office park are not similar assets. ABC considers the risks associated with operating the assets, obtaining tenants and tenant management between the single-family homes and office park to be significantly different because the scale of operations and risks associated with the class of customers are significantly different. Therefore, substantially all the fair value of the gross assets acquired is **not** concentrated in a single identifiable asset or group of similar identifiable assets. ABC must further evaluate whether the set has the minimum requirements to be considered a business.

The set has continuing revenues through the in-place leases and, therefore, has outputs. ABC must now determine whether the set includes both an input and substantive process that together significantly contribute to the ability to create outputs. ABC considers if any of these criteria are met:

- The acquisition does not include employees
- The acquired cleaning and security contract would be ancillary or minor in the context of all the processes required to create outputs in the real estate industry
- While the cleaning and security processes are necessary for continued operations of the buildings, these contracts can be quickly replaced with little effect on the ability to continue producing outputs
- The cleaning and security contracts are not considered unique or scarce

Because none of the criteria were met, ABC concludes the set does not include both an input and substantive processes that together significantly contribute to the ability to create outputs and is **not considered a business.**

Scenario 3

Assume the same facts as in Scenario 2, except that the set includes the employees responsible for leasing, tenant management and managing and supervising all operational processes.

The set has continuing revenues through the in-place leases and, therefore, has outputs. ABC must now determine whether the set includes both an input and substantive process that together significantly contribute to the ability to create outputs. Because the acquisition includes an organized workforce that performs critical processes—leasing, tenant management and supervision—to continue revenue production, ABC concludes the set includes both an input and substantive process, and **is considered a business.**

Appendix 3 – Acquisition of a Manufacturing Facility

Widget Co. manufactures complex equipment and has worldwide facilities. Widget Co. decided to idle a foreign facility as part of a reorganization and furloughed the assembly line employees. Acquirer enters into an agreement to purchase a manufacturing facility and related equipment from Widget Co. To comply with the local labor laws, Acquirer also must assume the furloughed employees. The assets acquired include the equipment and facility—land and building—but no intellectual property, inventory, customer relationships or any other inputs.

Acquirer first considers the threshold guidance. Acquirer concludes the equipment in the facility can be removed without significant cost or diminution in utility or fair value because it is not attached to the building and can be used in many types of manufacturing facilities. Therefore, the equipment and building are not a single asset. Furthermore, the equipment and facility are not considered similar assets because they are different major classes of tangible assets. Acquirer determines there is significant fair value in the equipment and the facility and concludes it must further evaluate whether the set has the minimum requirements to be considered a business.

The set is not currently producing outputs because there is no continuation of revenue before and after the transaction. Acquirer must consider whether the set includes both employees who form an organized workforce and an input that the workforce could develop or convert into output. The set includes employees who have the necessary skills, knowledge or experience to use the equipment. However, without intellectual property or other inputs that could be converted into outputs using the equipment, the set does not include both an organized workforce and an input, *i.e.*, those employees cannot develop or convert the equipment itself into an output. Therefore, **the set is not a business.**