Definition of a business

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Contents

A perspective on the new definition of a business

The FASB issued Accounting Standards Update (ASU) No. 2017-01, *Clarifying the Definition of a Business*, in January 2017. It provides a new framework for determining whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses.

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 significantly contribute to the ability to create outputs. The ASU creates a screening (initial) test (Step 1) that reduces the population of transactions that an entity needs to analyze to determine whether there is an input and a substantive process in the set (Step 2).

In certain industries such as real estate, a key difference between an acquisition of a group of assets and a business is that acquisition costs are included in the purchase price and capitalized as a component of acquired assets in an acquisition of a group of assets, whereas those costs generally are expensed as incurred in a business combination. A common misconception is that applying the initial screen in the ASU affects the separate recognition of identifiable assets. For example, land, building and leases that are combined for purposes of the initial screen are still ultimately recognized separately regardless of whether the set that is acquired is a group of assets or a business.

Given the accounting results, it is not surprising that many companies have early adopted the ASU or are considering early adoption. In this edition of Issues In-Depth, which supplements KPMG's Handbook, Accounting for Business Combinations and Noncontrolling Interests, we provide additional information to help entities apply the new definition of a business.

We hope this edition of Issues In-Depth will enhance your understanding and assist you in determining whether you acquired a group of assets or a business.

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About this publication

This publication looks in-depth at the definition of a business that was introduced by ASU 2017-01, *Clarifying the Definition of a Business*.

Organization of the text

Each section includes excerpts from the FASB's Accounting Standards Codification® and overviews of the relevant requirements. We include examples to explain key concepts, and we explain the changes from legacy US GAAP.

Our commentary refers to the Codification and to other literature, where applicable. The following are examples:

805-10-55-4 is paragraph 55-4 of Subtopic 805-10.

ASU 2017-01.BC59 is paragraph 59 of the basis for conclusions to ASU 2017-01.

You can find additional information about accounting for business combinations in KPMG's Handbook, Accounting for Business Combinations and Noncontrolling Interests.

1. A new definition

On January 5, 2017, the FASB issued ASU 2017-01, *Clarifying the Definition of a Business*.

ASU 2017-01 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017 (i.e. January 1, 2018 for public companies with a calendar year-end). For all other entities, it is effective for annual periods in fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning after December 15, 2019. An entity can early adopt the ASU and apply it to transactions that have not yet been reported in financial statements that have been issued or made available for issuance.

The FASB issued ASU 2017-01 to address the feedback received in the post-implementation review of Statement 141(R), *Business Combinations*, specific to the definition of a business. In that review, stakeholders informed the Board that the definition was applied too broadly and was difficult to apply in practice.

The new GAAP definition of a business does not impact the SEC definition of a business under Article 11 of Regulation S-X and related filing requirements – e.g. S-X Rule 3-05 for acquired business financial statements.

The following are key changes in the definition of a business as a result of ASU 2017-01.

	Old definition	New definition
Missing inputs or processes	A set is a business if a market participant could replace the missing elements.	A set must include at a minimum an input and a substantive process to be a business.
Screening test	None.	If substantially all the fair value is concentrated in a single asset (or group of similar assets) the set is not a business.
Definition of outputs	The result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.	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.
Presence of goodwill	Presumption that the set is a business.	Indicator of a substantive process in the set.

The evaluation of whether an acquired set of assets and activities (set) qualifies as a business may have significant accounting implications. For a transaction or event to be a business combination, the acquired set that the acquirer has obtained control over must constitute a business. This is an important determination, given the different accounting models for the acquisition of a group of assets versus a business.

— Business combinations are accounted for using the acquisition method that requires measurement of assets and liabilities at fair value with limited exceptions.
— Acquisitions of assets are accounted for using the cost accumulation and allocation model.

The following are significant differences in the accounting for the acquisition of a group of assets versus a business.

	Asset acquisition	Business combination
Initial measurement	Purchase price allocated on a relative fair value basis in accordance with paragraph 805-50-30-3. No goodwill or bargain purchase gain is recognized.	Identifiable assets and liabilities generally measured at fair value. Goodwill or bargain purchase gain may be recognized.
Measurement period	No concept of a measurement period exists in an asset acquisition.	The acquirer may record provisional amounts for the assets acquired and liabilities assumed and adjust them during the measurement period, which ends the earlier of (a) one year from the acquisition date, and (b) when the acquirer has obtained all relevant information about facts that existed at the acquisition date.
Direct acquisition related costs	Included in purchase price and capitalized as a component of acquired assets.	Generally expensed as incurred.
Bargain purchase amount	Allocated to identifiable nonfinancial assets on a relative fair value basis.	Recognized immediately in earnings as a gain.
Contingent consideration	Measured at fair value if the arrangement is a derivative. Otherwise, generally recognized when probable and estimable. Subsequent changes are recorded as adjustments to the cost of the assets.	Recognized at the acquisition date and measured at fair value. Subsequent changes to the fair value of liability-classified contingent consideration are recognized in earnings.

	Asset acquisition	Business combination
In-process research and development (IPR&D)	Purchase price allocated to IPR&D and expensed at the acquisition date 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.
Assembled workforce	Recognized as an intangible asset.	Recognized as a part of goodwill.
Deferred taxes	Temporary differences acquired should be accounted for using the guidance in Topic 740, *Income Taxes*. See section 10 of KPMG's Handbook, Accounting for Income Taxes.	Temporary differences are recognized for financial statement purposes (determined based on the provisions of Topic 805). Topic 740 requires an entity to recognize temporary differences that arise as a result of a business combination. See section 6 of KPMG's Handbook, Accounting for Income Taxes.
Disclosure requirements	No specific disclosure requirements; consider requirements in Topic 350, *Intangibles, Goodwill and Other*, Topic 360, *Property, Plant, and Equipment*, Topic 815, *Derivatives and Hedging* or Topic 450, *Contingencies*.	Extensive disclosure requirements.

2. Inputs, processes and outputs

Detailed contents

Excerpt from ASC 805-10

> > Definition of a Business

55-3A A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. To be considered a business, an integrated set must meet the requirements in paragraphs 805-10-55-4 through 55-6 and 805-10-55-8 through 55-9.

55-4 A business consists of inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business. The three elements of a business are defined as follows:

a. **Input.** Any economic resource that creates, or has the ability to contribute to the creation of, outputs when one or more processes are applied to it. Examples include long-lived assets (including intangible assets or rights to use long-lived assets), intellectual property, the ability to obtain access to necessary materials or rights, and employees.
b. **Process.** Any system, standard, protocol, convention, or rule that when applied to an input or inputs, creates or has the ability to contribute to the creation of outputs. Examples include strategic management processes, operational processes, and resource management processes. These processes typically are documented, but the intellectual capacity of an organized workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. Accounting, billing, payroll, and other administrative systems typically are not processes used to create outputs.
c. **Output.** 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.

55-5 To be capable of being conducted and managed for the purposes described in paragraph 805-10-55-3A, an integrated set of activities and assets requires two essential elements – inputs and processes applied to those inputs. A business need not include all the inputs or processes that the seller used in operating that business. However, to be considered a business, the set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output. Paragraphs 805-10-55-5A through 55-5C provide a practical screen to determine when a set would not be considered a business. If the screen is not met, further assessment is necessary to determine whether the set is a business. Paragraphs 805-10-55-5D through 55-6 and 805-10-55-8 through 55-9 provide a framework to assist an entity in evaluating whether the set includes both an input and a substantive process.

55-6 The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes, and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities. In addition, some transferred sets of assets and activities that are not a business may have liabilities.

Overview

The three elements of a business are inputs, processes and outputs. While a business typically has outputs, they are not required for a set to qualify as a business.

Inputs

Inputs are resources that contribute to the creation of outputs when processes are applied to the inputs. Generally, inputs are the assets in the set and include long-lived tangible assets (e.g. real estate and equipment), intangible assets (e.g. intellectual property, customer lists, trade names, patents and recipes), materials, contracts that provide the ability to obtain access to necessary materials or rights (e.g. distribution rights, mineral interests, broadcast rights, supply contracts and some service contracts) and employees.

Processes

Processes are systems, standards, protocols, conventions and rules that, when applied to inputs, create or have the ability to contribute to the creation of outputs. Processes typically include:

- **strategic management processes** – e.g. the overall vision and direction of the set that contribute to the creation of outputs and obtaining customers;
- **operational processes** – e.g. the fulfillment, production, development or customer acquisition processes that contribute to creating outputs; and
- **resource management processes** – e.g. processes involved in deploying resources such as raw materials and employees to produce outputs.

Accounting, billing, payroll and other administrative systems are typically not processes used to create outputs in most industries.

An entity could acquire a process even if it is not documented. While employees are an input, when they form an organized workforce, the capacity (e.g. knowledge, skills or experience) of that workforce to perform a process is acquired even if the process is not documented. In other words, the workforce itself is an input but the knowledge of the activities the workforce performs can be a process.

Outputs

Outputs are the result of processes applied to inputs that provide goods or services to customers, investment income (such as dividends or interest) or other revenues. In general, outputs give rise to the revenue of the set.

The FASB decided to align the definition of outputs with how that term is used in Topic 606, *Revenue from Contracts with Customers*. However, a set does not need to have contracts in the scope of Topic 606 to have outputs, because the definition includes 'investment income' and 'other revenues'. For example, a set could generate outputs as a result of leasing property in the scope of Topic 840, *Leases* (or Topic 842, *Leases*, once adopted).

An integrated set does not need to include all of the inputs and processes that the seller used in operating that set. For example, a set could qualify as a business if it was a division, product line or subsidiary of another entity. However, a set is only a business if it has, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. The evaluation requires an entity to consider the substance of what was acquired regardless of whether the missing elements (e.g. missing inputs and processes) could be replaced by a market participant.

Topic 805 includes two steps to determine if the minimum requirements to be a business are met. Step 1 is a screening (initial) test that, if met, results in the conclusion that the set is not a business. If Step 1 is not met, the entity evaluates whether the set includes an input and a substantive process (Step 2). However, before performing these steps an entity needs to identify the inputs, processes and outputs included in the set.

2.1 Determining what is a part of the set

In most cases, evaluating what is a part of the set will not be difficult, because the items included in the set will be explicitly identified in the contract between the acquirer and the seller. However, in other situations this analysis may not be straightforward and significant judgment will be required.

Employees

In some transactions, the acquirer will not acquire a legal entity of the seller; for tax or legal purposes this is often referred to as an 'asset acquisition' instead of a 'stock acquisition'. For the acquirer to acquire employees of the seller, the employees are terminated by the seller and hired by the acquirer. We believe the employees would be a part of the acquired set and the form of the transaction would not be relevant in these circumstances. However, all facts and circumstances need to be considered in determining whether employees are part of the acquired set.

Multiple transactions with the acquirer and seller

When an entity enters into multiple transactions to acquire assets or activities at or near the same time with the same counterparty, it evaluates whether the substance is a single transaction or multiple transactions.

An entity may enter into multiple transactions to acquire a business. Examples include the following.

— An entity initially purchases 30 percent of a business and then shortly thereafter purchases an additional 25 percent to gain control.
— An entity negotiates the acquisition of a business in aggregate, but consummates the acquisition by entering into separate legal agreements with each business subsidiary.

— Assets and processes are acquired over time that do not meet the definition of a business on an individual basis, but would constitute a business if evaluated together.

We believe the following factors listed in paragraph 810-10-40-6 (related to deconsolidation) may be considered to determine whether multiple transactions should be accounted for as a single transaction.

— They are entered into at the same time or in contemplation of one another.
— They form a single transaction designed to achieve an overall commercial effect.
— The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
— One arrangement considered on its own is not economically justified, but they are economically justified when considered together. An example is when one disposal is priced below market, compensated for by a subsequent disposal priced above market.

If an entity determines that each transaction should be accounted for separately, assets acquired and liabilities assumed would be evaluated and accounted for separately in accordance with applicable GAAP. Alternatively, if an entity determines that multiple transactions should be accounted for as a single transaction, those transactions would be evaluated and accounted for on a combined basis in accordance with applicable GAAP.

In addition to the factors in paragraph 810-10-40-6, the guidance in paragraphs 805-10-25-20 to 25-22, and 55-18 may be helpful in identifying whether a separate contract entered into between the acquirer and seller to provide future goods or services should be included in the set. That guidance indicates that some arrangements should be accounted for separately as a settlement of a pre-existing relationship, a transaction that compensates employees or former owners of the acquiree for future services, or a transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs. [805-10-25-20 – 25-21, 55-18]

When re-deliberating ASU 2017-01, the FASB observed that many entities used the guidance in paragraphs 805-10-25-20 to 25-22 and 55-18 to determine whether contractual arrangements were a part of the set; the FASB noted that entities should continue to use judgment. As a result, that guidance remains relevant for determining whether contracts between the acquirer and seller for future goods or services are a part of the acquired set. See section 11 of KPMG's Handbook, Accounting for Business Combinations and Noncontrolling Interests. [ASU 2017-01.BC49]

Other indicators that a contract that compensates the seller for future goods or services is *not* a part of the acquired set include when the future goods or services provided by the seller are:

— readily available in the marketplace; and
— an output of the seller's ordinary activities.

In addition, because the definition of a business is also relevant to the scope of derecognition guidance (i.e. Topic 810 and Subtopic 610-20), we believe it is also relevant to understand whether the seller disposed of an input or process. For example, if a contract between the acquirer and seller does not involve the seller transferring inputs or processes (e.g. it is a revenue contract from the perspective of the seller), then that transaction is not considered a disposal of an input or process by the seller, nor the acquisition of an input or process by the acquirer.

Example 1

Determining what is a part of the set – multiple transactions with the seller

Company A enters into a contract to sell a building to Company B. At the same time, Company A and Company B enter into a contract whereby Company A will provide property management services and Company B will compensate Company A for those services. The services are:

- readily available in the marketplace; and
- part of Company A's ordinary activities.

Company B evaluates whether the property management contract is a part of the set. Consistent with the guidance in paragraph 805-10-55-21, because the transaction compensates the former owners for future services, the transaction would be considered separate from the set. That is because the acquirer is compensating the seller for future property management services and the services are:

- readily available in the marketplace; and
- part of the seller's ordinary activities.

Furthermore, in the property management contract, Company A does not dispose of an input or process.

As a result, Company B concludes that the property management contract is not a part of the acquired set.

2.2 Contractual arrangements

A contract that is separately negotiated and entered into with an independent third party by the acquirer is typically not a part of the set even if it was entered into at or near the same time or relates directly to the acquirer's operation of the set. However, when the seller and third party previously had a contractual relationship that transfers to the acquirer, the determination may not be as clear.

When evaluating whether a third-party contract is a part of the set, the objective is to determine if the acquirer and third party entered into a separately negotiated contract or if the seller transferred the contract to the acquirer. In many cases, this will be a legal distinction because a contract is either acquired through a legal entity or assigned by the seller to the acquirer. However, entities should also evaluate the substance of the arrangement when the acquirer and third party enter into a contract directly.

To make this evaluation, entities should consider the following factors (not exhaustive).

- Whether the acquirer and third party entered into **substantive negotiations to continue the relationship**. If the contract between the acquirer and third party was the result of a bona fide negotiation, it may indicate the contract is not a part of the set. In contrast, if the contract was not the result of a bona fide negotiation, it may indicate the contract is a part of the set.
- Whether it is **feasible to change vendors**. If changing vendors is not feasible (even if available in the marketplace) because of a significant cost of changing or disruption caused by the change, it might indicate that the negotiations between the acquirer and third party are not substantive and the contract is a part of the set. In contrast, the fact that it is convenient to maintain the same vendor would not necessarily indicate the change was not feasible.
- Whether the **goods or services are readily available in the marketplace**. If the services are unique or scarce such that the acquirer would not be able to obtain the goods or services elsewhere, it might indicate that the seller transferred the contractual relationship to the acquirer. If the goods or services can be obtained in the marketplace, it might indicate that the contract is a separately negotiated contract and not a part of the set.
- **Whether the transaction can be closed without the contract transferring**. For example, if the contract between the acquirer and seller includes a contingency that requires the contract between the acquirer and a third party to be entered into, it would indicate the contract is a part of the set.

Example 2

Determining what is a part of the set – contractual arrangement with a third party

Company A owns a hotel property and has an at-market in-place contract with Manager X to manage that property. Company B acquires the hotel from Company A.

Consider the following scenarios.

- **Scenario 1.** The contract between Company A and Manager X has a change-in-control provision that automatically terminates the contract on sale of the property. Company B and Manager X must enter into a new contract and neither party is required to continue the relationship. Company B and Manager X enter into a new contract with substantially similar terms.

  The contract is not a part of the set because Company B and Manager X had substantive negotiations to enter into the new contract, the services are readily available in the marketplace, the entity could reasonably replace the vendor with another party without a significant disruption in operations and the consummation of the transaction was not dependent on entering into the new agreement.

- **Scenario 2.** The contract between Company A and Manager X does not terminate on sale of the property and Company A can assign the contract to other parties. Company A assigns the management contract to Company B as a part of the transaction.

  The contract is a part of the set. The contract transferred from Company A to Company B. While the services are readily available in the marketplace, there were no substantive negotiations between Company B and Manager X.

- **Scenario 3.** The contract between Company A and Manager X does not terminate on sale of the property and is assignable to other parties. At Company B's request, Company A terminates the contract with Manager X before the close of the transaction. Company B and Manager X enter into a new contract with terms that are substantially the same as the contract between Company A and Manager X; however, the transaction could not close until Company B and Manager X had a new contract in place.

  The contract is a part of the set. In substance, the contract transferred from Company A to Company B. While Company B and Manager X entered into a new contract, it was not a result of a separate negotiation but rather the transaction was dependent on Company B and Manager X entering into the same contract. Furthermore, Company A and Manager X only terminated the contract to help facilitate the transaction closing.

3. Step 1: Screening test

Detailed contents

Excerpt from ASC 805-10

> > Single or Similar Asset Threshold

55-5A If substantially all of 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. Gross assets acquired should exclude cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. However, 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.

> > > Single Identifiable Asset

55-5B 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. However, for purposes of this evaluation, the following should be considered a single asset:

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

> > > Similar Assets

55-5C A group of similar assets includes multiple assets identified in accordance with paragraph 805-10-55-5B. 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 (that is, the risk characteristics). However, the following should not be considered similar assets:

a. A tangible asset and an intangible asset
b. Identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development)
c. A financial asset and a nonfinancial asset
d. Different major classes of financial assets (for example, accounts receivable and marketable securities)
e. Different major classes of tangible assets (for example, inventory, manufacturing equipment and automobiles)
f. Identifiable assets within the same major asset class that have significantly different risk characteristics.

Overview

Step 1 is an initial screen to determine when a set is not a business. Step 1 requires that when substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. However, if Step 1 is not met, the entity will still need to evaluate Step 2 to determine if the set is a business.

While Step 1 is required, an entity could choose to go directly to Step 2 if it concludes under Step 2 that the set is not a business. That is because Step 1 could not contradict that conclusion. However, an entity will need to appropriately evaluate Step 1 before concluding that a set is a business, because Step 1 is determinative that a set is not a business regardless of an entity's interpretation of Step 2.

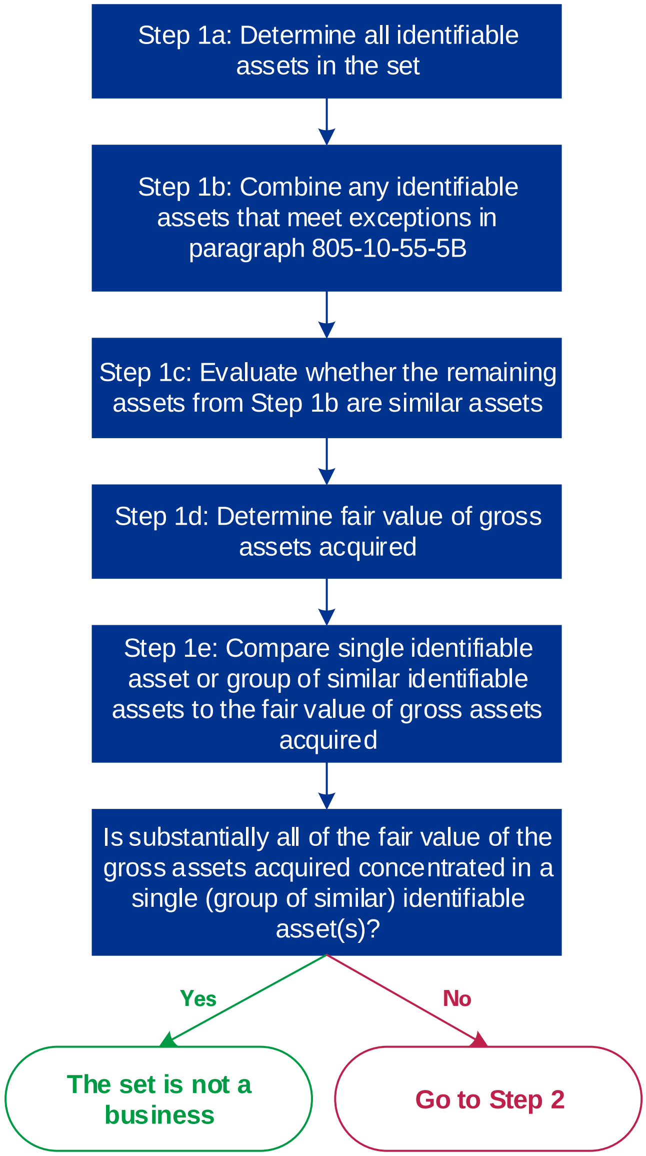
There may be circumstances when Step 1 could be completed solely on a qualitative basis as discussed in the basis for conclusions.

Excerpt from ASU 2017-01

BC19 The assessment could be qualitative if, for example, an entity concludes that all of the fair value will be assigned to one element of the acquisition. For example, if the acquisition includes a license for a drug candidate and an at-market contract and the entity concludes that the at-market contract has at the date of assessment little or no fair value assigned to it or the fair value of a single identifiable asset or group of similar identifiable assets is so significant that it is very clear that the threshold will be met, the entity may conclude that the threshold has been met. If there are multiple assets that the entity concludes will have more than an insignificant value assigned, the entity may be able to qualitatively conclude that there is clearly significant value in assets that are not similar and that the threshold is not met and go on to the rest of the framework. However, an entity must determine the fair value of each asset to allocate the consideration to assets recognized in both an asset acquisition and a business combination…if the set is not a business, an entity could choose to document its conclusion in the most cost-effective manner depending on its situation.

We would expect an entity to document its qualitative analysis and its considerations to conclude the screening test is met without a quantitative analysis.

The following flowchart illustrates the steps that may be useful when applying Step 1.



3.1 Step 1a: Determine all identifiable assets in the set

In Step 1a, an entity would determine all identifiable assets in the set. The basis for conclusions states, "For ease of application, the Board decided that an entity should use the same unit of account when assessing the threshold that it would use for identifying assets recognized in a business combination even if it results in some tangible assets and intangible assets being combined into a single asset." [ASU 2017-01.BC 24]

As a result, the starting point is to determine what assets would be recognized under Topic 805 if the set were considered a business rather than a group of assets.

For example, in a business combination an entity would recognize and measure an in-process research and development (IPR&D) asset, but it typically would not recognize IPR&D as an asset in an asset acquisition. Because the unit of account is the same as in a business combination, a single IPR&D asset would be considered a single identifiable asset for purposes of applying Step 1.

In contrast, an assembled workforce (or goodwill) is not an 'identifiable asset' that could be recognized in a business combination, but an assembled workforce intangible asset could be recognized in an asset acquisition. Because the unit of account is the same as in a business combination, an assembled workforce intangible asset would not be considered a single identifiable asset for purposes of applying Step 1.

A single identifiable asset could also include certain complementary intangible assets that are recognized and measured as a single asset in a business combination. For example, Topic 805 states, "The terms *brand* and *brand name*, often used as synonyms for trademarks and other marks, are general marketing terms that typically refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes, and technological expertise. This Subtopic does not preclude an entity from recognizing, as a single asset separately from goodwill, a group of complementary intangible assets commonly referred to as a brand if the assets that make up that group have similar useful lives." [805-20-55-18]

Similarly, some tangible assets and intangible assets (e.g. a nuclear power plant and a license to operate it) that are combined for financial reporting purposes in a business combination would also be considered a single identifiable asset for purposes of Step 1. [805-20-55-2(b)]

Example 3
Applying Step 1a

Company X acquires five separate apartment complexes. Each complex includes land, building, property improvements and at-market in-place tenant leases. Company X first determines the identifiable assets that could be recognized separately in a business combination.

The land, building, property improvements and in-place leases would be recorded as separately identifiable tangible and intangible assets. Company X also identifies an intangible asset for the trade name associated with the apartment complexes.

As a result, the identifiable assets in the set include five parcels of land, five buildings, various property improvements, the in-place lease intangible assets at each complex and the trade name intangible asset.

3.2 Step 1b: Combine any identifiable assets that meet the 55-5B exceptions

There are two exceptions to the general rule discussed in Step 1a. These exceptions require an entity to combine assets that would be considered separately identifiable in a business combination as a single asset **only** for purposes of applying Step 1.

Those exceptions are to consider as a single identifiable asset:

— a tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset (or an intangible asset representing the right to use a tangible asset) without incurring significant cost or significant diminution in utility or fair value to either asset (e.g. land and building); and

— in-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets. [805-10-55-5B]

While identifiable assets that meet these exceptions are combined as a part of Step 1b, they generally would be recorded separately regardless of whether the set is a group of assets or a business. For example, a building and an in-place lease should be measured and recorded separately regardless of whether the acquired set meets the definition of a business.

The FASB included the exceptions in Step 1b to allow practical application of Step 1 in certain transactions. For example, in real estate transactions, land and buildings are often transferred together, but are considered separate assets for accounting purposes. Without the first exception that allows the combination of tangible assets, these transactions would rarely meet Step 1.

The second exception was included to promote consistency between real estate transactions in Step 1 so that an entity would not get a different outcome for similar transactions solely because the value of the leases was different or because the lease had above or below market rents.

We believe the exception for lease intangibles should be interpreted narrowly – i.e. it should be applied only when the contract meets the definition of a lease in Topic 840 or Topic 842, once adopted; entities should not make analogies to combine other contracts and assets.

Example 4
Applying Step 1b

The following is a continuation of Example 3.

Company X evaluates whether any of the exceptions in paragraph 805-10-55-5B (Step 1b) apply. Company X concludes that the land, building, property improvements and in-place leases at each property (apartment complex) are a single asset for the following reasons:

— the building and property improvements are attached to and cannot be physically removed from and used separately from the land without incurring significant costs or reducing their fair value; and

— the in-place lease intangibles for each apartment are required to be combined with the leased asset.

After applying the exceptions, the set has six single identifiable assets (i.e. the combined land, building, property improvements and leases at each of the five properties are one asset and the trade name intangible asset). The exceptions in Step 1b do not apply to the trade name intangible asset.

3.3 Step 1c: Evaluate whether the remaining assets from Step 1b are similar assets

In Step1c, an entity evaluates whether the assets identified in Step 1b are similar. However, an entity that acquires a combined single asset (e.g. the combined land, building, property improvements and leases in Example 4) does not need to evaluate components of that combined single asset for similarity. For example, it is not necessary to consider whether the commercial and retail space in a single real estate asset are different or similar. The analysis of significantly different risks is only about comparing an individual or combined asset identified in Step 1b with another individual or combined asset identified in Step 1b.

ASU 2017-01 states, "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 (that is, the risk characteristics)." [805-10-55-5C]

In addition, that paragraph identifies types of assets that should not be considered similar, including: [805-10-55-5C]

a. a tangible asset and an intangible asset;
b. identifiable intangible assets in different major intangible asset classes – e.g. customer-related intangibles, trademarks and IPR&D;
c. a financial asset and a nonfinancial asset;
d. different major classes of financial assets – e.g. accounts receivable and marketable securities;
e. different major classes of tangible assets – e.g. inventory, manufacturing equipment and automobiles; and

f. identifiable assets within the same major asset class that have significantly different risk characteristics.

Paragraph 805-10-55-5C(a) states that a tangible asset and an intangible asset should not be considered similar. This factor is applied only after assets are combined in accordance with paragraph 805-10-55-5B in Step 1b. Accordingly, an entity does not need to separate a tangible and an intangible asset (e.g. real estate asset and related lease intangible) in Step 1c when applying the above factors.

Furthermore, the individual combined assets (e.g. real estate asset and related lease intangible) could be considered similar to other assets that are identified in Step 1b. For example, a combined apartment complex and related leases would be compared to other assets to determine if they are similar assets and may be grouped with other similar combined assets (e.g. other combined apartment complexes and related leases) if the other criteria to be a similar asset are met. Also, an apartment complex that is combined with lease intangibles in Step 1b may be combined with a similar apartment complex without leases if there are similar risks associated with managing and creating outputs from the assets.

Significant judgment will be required to determine if single assets within a major asset class have significantly different risk characteristics (factor (f)). "The Board clarified that the risks to be evaluated should be linked to the risks associated with the management of the assets and creation of outputs because this assessment may be instructive on whether an integrated set of assets and activities has been acquired. That is, when the risks associated with managing and creating outputs from the assets are significantly different, the set would need more sophisticated processes to manage and create outputs." As a result, the relevant analysis is whether the risks associated with creating outputs are significantly different. [ASU 2017-01.BC31]

We believe an entity should consider the risks associated with the management of the assets and the creation of outputs from the perspective of a market participant; see discussion of the market participant perspective in section 4.5 – Market participant concept. It is not necessarily relevant how the acquirer intends to operate the set, or how the seller operated the set, when determining the risks associated with the assets. [805-10-55-8]

An entity should consider different risk factors depending on the nature of the asset. For example, real estate and intellectual property have different risk characteristics to analyze. Entities may also need to consider different types of risks for assets within a particular industry.

The following table summarizes risk factors and examples associated with operating and managing the assets to create outputs that may be relevant based on the nature of the asset (not exhaustive). These risks will need to be significant to affect the conclusion of whether assets are similar, and while these factors may be present in a particular transaction, they may not be determinative and all facts and circumstances should be evaluated.

Type of assets	Risk factors	Examples of assets that may have significantly different risks
Real estate	**Geographic location**	– Property in a developing or volatile economy versus a stable and low volatility economy – Properties in jurisdictions or countries with significantly different regulations – Single-family home in a large metropolitan area (population > 2 million) versus a single-family home in a small town (population < 10,000)
	Class of customers	– Four-star hotel versus a two-star hotel – Commercial office building versus residential property – Tenants with a high risk of default versus tenants with a low risk of default
	Size of the properties	– Office building with two floors versus an office building with 30 floors – Shopping center (e.g. with five tenants) and a shopping mall (with many tenants)
	Market risk	– Property in a high growth area versus a property in a low growth area – Significant cost to obtain tenants versus property with a waiting list to become a tenant
	Types of assets	– Residential versus commercial real estate – Hotel versus commercial real estate – Apartment building versus a single-family home
Life sciences	**Development risk**	– Drug compounds in different stages of FDA approval (e.g. Stage 2 versus Stage 3) – Commercialized drug versus development stage compound
	Class of customers	– Drug compounds that treat (or are intended to treat) different diseases (i.e. the patients have different demographics)
	Market risks	– Generic brand versus premium brand – Commercialized product with generic competition versus product with patent protection
Financial assets	**Credit risk**	– High quality bond versus junk bond – Loan to a large multinational company with a high credit rating versus a loan to a start-up company with a low credit rating
	Term	– Three-year loan versus a 20-year loan
	Type	– Mortgage loan versus commercial loan

Type of assets	Risk factors	Examples of assets that may have significantly different risks
Oil and gas assets	**Development risks**	– Property in shallow water versus property in ultra-deep water – Property in location with known adverse weather conditions versus property with moderate weather conditions – Offshore properties versus onshore properties
	Jurisdiction (laws and regulations)	– Property in highly regulated country versus property in less regulated country – Property in country with unstable government versus property in country with stable government – Property in area with access to a workforce (e.g. local workforce available) and property in area with no workforce (e.g. workforce must be transported to site)
Transportation assets	**Type of asset**	– Assets that perform different functions (e.g. cargo aircraft versus a passenger aircraft) – Oil tanker and cargo ship
	Market risks	– Assets designed to operate in locations with known adverse weather conditions versus assets designed to operate in moderate weather conditions – Assets (e.g. newer models, better technology or unique functions) that demand higher rates from customers such as a boat with a day rate of $30,000 versus a boat with a day rate of $10,000

Example 5
Applying Step 1c

The following is a continuation of Examples 3 and 4.

The acquired apartment complexes are all in the same metropolitan area and have a similar class of customers. There are differences in prices charged for apartments on lower floors and apartments with a view. However, the ratio of price differences between apartments on lower floors and apartments with views is reasonably consistent at each apartment complex. The trade name intangible asset is not a similar asset to the apartment complexes (i.e. tangible assets) as a tangible asset and an intangible asset (except for lease intangibles and leased assets) are not similar.

Company X concludes that the five apartment complexes are similar assets because the risks of operating the assets and creating outputs from these assets are not significantly different.

Geographic location should be considered when determining whether real estate assets are similar assets. Apartment complexes in different parts of the United States or different parts of the same metropolitan area may not be similar assets if the risks associated with producing outputs (e.g. lease income) in different geographical locations are significantly different. Also, if there was another type of asset acquired in the transaction, such as an office building or hotel, they would not be similar to apartment complexes because they are different tangible assets.

3.4 Step 1d: Determine fair value of gross assets acquired

In Step 1d, the entity determines the fair value of gross assets acquired (i.e. the denominator). The gross assets acquired generally include all assets that are recognized in a business combination including goodwill. The denominator also includes consideration transferred (plus the fair value of noncontrolling interests and previously held interests, if any) in excess of the fair value of net identifiable assets acquired. The consideration transferred would also include contingent consideration determined under Topic 805 because contingent consideration may affect the value of goodwill, which is included in gross assets. Additionally, an assembled workforce, which is not a recognized intangible asset in a business combination, would be included in the denominator by virtue of its inclusion in goodwill.

The FASB specifically excluded items from the numerator and denominator such as cash and cash equivalents, deferred tax assets and goodwill resulting from the effects of deferred tax liabilities. Cash and cash equivalents are excluded to prevent entities from increasing the purchase price with no economic substance (e.g. by choosing to include a greater amount of cash or cash equivalents in the acquired set) to avoid a conclusion that substantially all of the fair value is concentrated in a single asset (or group of similar assets).

The deferred tax items are excluded because those items are a reflection of the legal or tax form of the transaction rather than the substance of what was acquired.

Except for unfavorable lease intangible liabilities, which are combined with the related leased asset, the numerator and denominator exclude all debt or other liabilities because the assumption of those liabilities may simply be a financing mechanism for the transaction. The Board indicated in paragraph BC20 of ASU 2017-01 that it decided to exclude liabilities from the screening test to avoid "a group of assets that would otherwise be subject to further evaluation under the model bypassing such evaluation solely because a transaction includes liabilities in addition to assets." Following this rationale, we believe that a gain from a bargain purchase also should be excluded from (i.e. it does not reduce) the denominator. Paragraph 805-10-55-5A states that gross assets should include any consideration transferred in excess of the fair value of net identifiable assets acquired. Paragraph 805-10-55-5A does not specifically state that gross amounts should include any deficit (i.e. bargain purchase amount). Including a bargain purchase amount in the numerator and denominator would distort the screening test in a manner similar to including liabilities.

We believe that the exclusion of all liabilities (except for unfavorable lease intangible liabilities) from the numerator and denominator of the screening test also applies to asset retirement obligations related to assets included in the set. That is, an asset retirement obligation should not be netted against (should not reduce) the fair value of the assets included in the numerator and denominator. For example, assume an entity acquires a set that includes a manufacturing facility with an associated asset retirement obligation. The entity determines the fair value of the manufacturing facility to be $100 million (net of an asset retirement obligation of $20 million). In accounting for the acquisition, the entity would record the manufacturing facility at $120 million and a liability for the asset retirement obligation at $20 million. In applying the screening test, the entity would include the manufacturing facility with a value of $120 million in both the numerator and denominator.

However, the presence of an asset retirement obligation may be a relevant qualitative factor to consider in Step 1e discussed below.

Example 6
Applying Step 1d

The following is a continuation of Examples 3, 4 and 5.

For this example, Company X also assumes debt associated with building the apartment complexes of $2,500,000 and cash on hand of $50,000. Company X paid a purchase price of $25,600,000.

Company X determines the fair value of the gross assets acquired to determine the denominator.

Items acquired / assumed	Estimated fair value	Included in gross assets
Apartment complex 1	$ 5,100,000	$ 5,100,000
Apartment complex 2	$ 4,850,000	$ 4,850,000
Apartment complex 3	$ 5,650,000	$ 5,650,000
Apartment complex 4	$ 5,400,000	$ 5,400,000
Apartment complex 5	$ 5,200,000	$ 5,200,000
Assumed debt	$ (2,500,000)	Not included
Cash on hand	$ 50,000	Not included
Trade names	$ 1,850,000	$ 1,850,000
Total	**$25,600,000**	**$28,050,000**

The fair value of gross assets acquired is $28,050,000 in this example. Cash, debt assumed, deferred taxes (if any) and goodwill resulting from the effects of deferred tax liabilities (if any) are not included in gross assets acquired.

3.5 Step 1e: Compare the single identifiable asset or group of similar identifiable assets to the fair value of gross assets acquired

In Step 1e, an entity compares the fair value of the single identifiable asset (or group of similar assets) to the fair value of the gross assets acquired. To do that, an entity would identify the individual identifiable asset with the greatest fair value or group of similar identifiable assets with the greatest fair value (whichever is greater). Next the entity compares that amount to the fair value of the gross assets acquired as determined in Step 1d. If the fair value of that single identifiable asset or group of similar identifiable assets represents substantially all of the fair value of the gross assets, then the screening test is met and the set is not a business.

The FASB decided to use the term 'substantially all' because it is commonly used throughout US GAAP. However, the FASB did not specify a quantitative threshold for what 'substantially all' means in Step 1. In other US GAAP, substantially all is generally interpreted to mean approximately 90 percent or greater; however, for purposes of the definition of a business, substantially all is not necessarily meant to be a bright-line quantitative threshold.

When there is uncertainty about whether the 'substantially all' test is met (e.g. because the ratio is close to the quantitative threshold or the valuation of assets acquired is based on unobservable (Level 3) fair value measurement inputs subject to significant measurement uncertainty), we believe qualitative factors may also be considered. The purpose of a qualitative assessment is to evaluate whether the other assets in the set have substance, in which case Step 2 should be performed. We believe relevant qualitative factors include but are not limited to the following.

- **The composition of other assets.**
  - If the other assets are equipment or materials that can be easily replaced at a cost that is insignificant in relation to the fair value of the set, that may qualitatively indicate that the substantially all threshold is met because those other assets are not substantive.
  - If the other tangible or intangible assets complement the primary asset (e.g. a customer list accompanying a significant developed technology intangible asset), that may qualitatively indicate that the other assets are substantive and an entity should move to Step 2.
- **The set includes employees and goodwill.** The presence of goodwill is an indicator of a substantive process in the set. If the set includes employees and a more than insignificant amount of goodwill, that may indicate that an entity should move to Step 2 to evaluate whether the employees represent an organized workforce, in which case a substantive process would be present and the set likely would be a business.
- **The set is self-sustaining.** If the set is self-sustaining (i.e. the set was a stand-alone entity or a largely independent division, subsidiary or product line of a larger entity), that may qualitatively indicate that in substance an entity is acquiring more than just a single asset and the other elements are substantive; therefore the entity should move on to Step 2.

— **An asset retirement obligation is included in the set.** Asset retirement obligations, although excluded from the substantially all quantitative test, generally are associated with the normal operation of long-lived assets. If exclusion of an asset retirement obligation associated with an asset in the set is the reason a quantitative threshold has been met, that may qualitatively indicate that in substance an entity acquired more than just a single asset and the other elements are substantive depending on the nature and composition of the other assets.

We would expect entities to apply the quantitative and qualitative factors consistently to similar transactions. In general, we would place greater emphasis on the quantitative assessment when there is a higher concentration of fair value in a single asset (or group of similar assets) or the fair value measurements of the assets are not subject to significant measurement uncertainty. As a result, qualitative factors ordinarily would not overcome the quantitative assessment when the fair value of a single asset (or group of assets) is well above 90 percent of the fair value of the gross assets even if employees are included in the set.

In contrast, we believe it would be rare for an entity to conclude that Step 1 is met when the concentration of fair value is more than just a few percentage points less than 90 percent of the fair value of the gross assets.

Example 7
Applying Step 1e

The following is a continuation of Examples 3, 4, 5 and 6.

Company X evaluates whether the fair value is concentrated in a single asset or group of similar assets.

In Step 1d, the fair value of the gross assets acquired was determined to be $28,050,000. The apartment complexes were found to be similar and are grouped together for Step 1. In Step 1e, the combined value of $26,200,000 is compared to the gross assets acquired of $28,050,000.

This results in 93 percent of the value of the gross assets acquired being associated with a group of similar assets. Company X also considers qualitatively whether in substance it acquired a group of similar assets and whether the other elements are substantive. Company X determines the other elements (e.g. trade names) acquired are not substantive because the other elements are not a result of goodwill and an organized workforce, and the set was not a stand-alone self-sustaining operation.

The quantitative and qualitative factors indicate that, in substance, the entity acquired a group of similar assets and the set is not a business.

Example 8

Applying Step 1 when goodwill results from the effects of deferred tax liabilities

Company A acquires 100% of Biotech Corp. on January 1, 20X9 for $10,000,000. Biotech's operations include IPR&D activities on a single development stage drug compound. No employees are included in the set. The enacted tax rate is 25% for 20X9 and all future years.

The identifiable assets acquired and liabilities assumed have the following fair values and tax bases.

	Estimated fair value	Tax basis	Temporary difference
Cash	$ 50,000	$ 50,000	$ -
IPR&D	$ 9,450,000	$ -	$ 9,450,000
Research lab	$ 400,000	$ 200,000	$ 200,000
Current liabilities, excluding deferred taxes	$ (200,000)	$ (200,000)	$ -
Identifiable net assets acquired	$ 9,700,000	$ 50,000	$ 9,650,000

The assets acquired and liabilities assumed would be recognized under Topic 805 as follows:

Cash		$ 50,000
IPR&D		$ 9,450,000
Research lab		$ 400,000
Current liabilities		$ (200,000)
Deferred tax liabilities		$ (2,412,500)
Goodwill		$ 2,712,500
Consideration paid		**$ 10,000,000**

Step 1a

Company A determines the identifiable assets that could be recognized separately in a business combination. As shown above, the identifiable assets in the set include cash, IPR&D and the research lab.

Step 1b

Company A evaluates whether any of the exceptions apply. Company A concludes that none of the assets meet the exceptions and none of the acquired assets are combined.

Step 1c

Company A concludes that none of the acquired identifiable assets (e.g. cash, IPR&D and the research lab) are similar assets.

Step 1d

The gross assets acquired would not include the goodwill associated with the deferred tax liabilities acquired in this transaction. The deferred tax liabilities acquired in this example generated $2,412,500 of goodwill, which is excluded for purposes of applying Step 1, leaving $300,000 of goodwill.

The gross assets acquired in this example for purposes of Step 1 are shown in the table.

Items acquired / assumed	Value under Topic 805	Included in gross assets
Cash	$ 50,000	Not included
IPR&D	$ 9,450,000	$ 9,450,000
Research lab	$ 400,000	$ 400,000
Current liabilities	$ (200,000)	Not included
Deferred tax liabilities	$ (2,412,500)	Not included
Goodwill	$ 2,712,500	$ 300,000
Total	**$ 10,000,000**	**$ 10,150,000**

The fair value of gross assets acquired is $10,150,000.

Step 1e

Company A evaluates whether the fair value is concentrated in a single asset or group of similar assets.

In Step 1d, the fair value of the gross assets acquired was determined to be $10,150,000. As previously discussed, none of the acquired assets were found to be similar and none are grouped together for Step 1c. In Step 1e, the largest acquired asset had a value of $9,450,000 and is compared to the gross assets acquired of $10,150,000.

This results in 93% of the value of the gross assets acquired being associated with a single identifiable asset (e.g. IPR&D). Company A also considers qualitatively whether in substance the other elements (e.g. research lab, goodwill) of the transaction are substantive. While the set includes goodwill, the value associated with the goodwill is de minimis (below 3%) and is not attributable to an organized workforce because there are no employees acquired. As a result, the quantitative and qualitative factors indicate that substantially all the fair value is concentrated in a single asset and the set is not a business.

Example 9
Applying Step 1 when a bargain purchase exists

ABC Corp. enters into a purchase agreement to acquire a small software company (Target) for $9,000,000. Target has five employees that are software developers, earns some revenue, but is not profitable. Target's owners believe its software alone is worth more than the purchase price. However, Target is running out of money and its owners are willing to sell to ABC at a significant discount.

Target's software has a fair value of $10,000,000 and it has a customer-related intangible with a fair value of $500,000.

ABC's senior management and IT department believe Target's five software developer employees can be replaced after consummation of the transaction without significant time, effort or delay in the ability to continue producing outputs, as they are not considered essential (e.g. the software is already developed).

ABC determines that it should exclude the bargain purchase amount from the numerator and denominator in Step 1. Because an assembled workforce is not a recognized identifiable asset in a business combination (and because there is no goodwill in this example), ABC will exclude the assembled workforce from Step 1.

ABC performs Step 1 to evaluate whether the fair value is concentrated in a single asset or group of similar assets.

Items acquired / assumed	Value under Topic 805	Included in gross assets
Software	$ 10,000,000	$ 10,000,000
Customer-related intangible	$ 500,000	$ 500,000
Bargain purchase	$ (1,500,000)	Not included
Total	**$ 9,000,000**	**$ 10,500,000**

ABC compares the largest acquired asset (software) valued at $10,000,000 to the fair value of gross assets acquired of $10,500,000.

This results in 95% of the value of the gross assets acquired being associated with a single identifiable asset. ABC also evaluates whether qualitatively, the other elements (customer-related intangible and employees) are substantive. There is no goodwill associated with the set (i.e. there was no value in the assembled workforce since the employees can easily be replaced) and the value of a single asset is well above 90%. ABC concludes that substantially all the fair value is concentrated in a single asset and the set is not a business.

Example 10
Acquisition of loan portfolio – Scenario 1[1]

Facts

— Bank A acquires a portfolio of residential mortgages and a portfolio of commercial mortgages, each having significant value and significantly different risks (e.g. term, size and risk ratings).

— Bank A does not acquire the employees that manage the credit risk of the loan portfolios and had relationships with the borrowers in the acquisition. Bank A does not acquire other protocols, conventions or systems.

— The loan portfolios currently produce outputs (interest income).

Analysis

Step 1 (screening test)

Bank A concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable asset(s). This is because the two loan portfolios have significantly different risk characteristics and are not similar assets.

The fair value of the gross assets is spread across the two identifiable assets (loan portfolios); therefore, Step 1 is not met.

Step 2 (input and substantive process)

See Example 15 for the analysis of Step 2.

Conclusion

The acquired set does not meet the screening test (Step 1); therefore, Step 2 is required.

Example 11
Acquisition of oil and gas properties – Scenario 1

Facts

— XYZ Co. acquires the mineral rights (i.e. lease agreements to develop and produce the underlying mineral reserves) in certain properties in the southwest shale.

— The acquisition provides XYZ Co. with an average 50% working interest in the properties.

— The properties are proved and unproved properties. The proved properties are currently producing oil and gas. The properties classified as unproved have known reserves (they have been 'proved up') but are classified as unproved because of the requirement to classify properties as unproved if an entity does not expect to produce from those properties within the next 5 years.

1 Based in part on Case H, Scenario 2, in ASU 2017-01

— XYZ Co. also assumes customer contracts in the acquisition, which are at market rates. No employees are in the set.

Analysis

Step 1 (screening test)

The oil and gas properties are found to be two single identifiable assets that would be recognized in a business combination under Topic 805. The two assets are proved and unproved properties. Even though they have different disclosure requirements, we believe that proved and unproved oil and gas properties can be considered to be within the same major asset class and therefore could be considered similar assets if they do not have significantly different risks. When evaluating whether those assets are similar, an entity should consider the nature of proved and unproved properties and the risks associated with managing and creating outputs from the proved and unproved properties (i.e. the risk characteristics).

In this example, the two identified assets do not have significantly different risks associated with creating outputs and therefore are similar assets. They are similar assets because they are in the same geographic area (e.g. southwest shale) and are expected to have similar outputs (e.g. mix of hydrocarbons) from both assets. The unproved properties, while not meeting the proved definition because XYZ Co. does not expect to produce from those properties over the next five years, are considered to have the same risk profile as the proved properties because they have known reserves.

If the unproved properties had not already been 'proved up,' XYZ Co. may have concluded that the proved and unproved properties have significantly different risks. Additionally, oil and gas properties in different regions of the United States, in different jurisdictions, and those that have different characteristics such as offshore and onshore could result in different conclusions about whether they are similar and would require analysis of the specific facts and circumstances.

There is no fair value associated with the customer contracts because the contracts are at market rates and are readily available in the market place, and there were no other assets acquired. Accordingly, XYZ Co. concludes that substantially all of the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets (the proved and unproved oil and gas properties). Step 1 is met and the set is not a business.

4. Step 2: Evaluate whether an input and a substantive process exist

Detailed contents

Excerpt from ASC 805-10

> > > Framework – Inputs, Substantive Processes, and Other Considerations

55-5D When a set does not have outputs (for example, an early stage company that has not generated revenues), the set will have both an input and a substantive process that together significantly contribute to the ability to create outputs only if it includes employees that form an organized workforce and an input that the workforce could develop or convert into output. The organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs. An entity should consider the following in evaluating whether the acquired workforce is performing a substantive process:

a. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all the processes required to create outputs.
b. Inputs that employees who form an organized workforce could develop (or are developing) or convert into outputs could include the following:
   1. Intellectual property that could be used to develop a good or service
   2. Resources that could be developed to create outputs
   3. 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.

55-5E When the set has outputs (that is, there is a continuation of revenue before and after the transaction), the set will have both an input and a substantive process that together significantly contribute to the ability to create outputs when any of the following are present:

a. Employees that form 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 or inputs is critical to the ability to continue producing outputs. A process (or group of processes) 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.
b. 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 or inputs is critical to the ability to continue producing outputs. An entity should assess the substance of an acquired contract and whether it has effectively acquired an organized workforce that performs a substantive process (for example, considering the duration and the renewal terms of the contract).
c. The acquired process (or group of processes) when applied to an acquired input or inputs 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.

d. The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and is considered unique or scarce.

55-5F If a set has outputs, continuation of revenues does not on its own indicate that both an input and a substantive process have been acquired. Accordingly, assumed contractual arrangements that provide for the continuation of revenues (for example, customer contracts, customer lists, and leases [when the set is the lessor]) should be excluded from the analysis in paragraph 805-10- 55-5E of whether a process has been acquired.

55-6 The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes, and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities. In addition, some transferred sets of assets and activities that are not a business may have liabilities.

55-8 Determining whether a particular set of assets and activities is a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Thus, in evaluating whether a particular set is a business, it is not relevant whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business.

55-9 When evaluating whether a set meets the criteria in paragraphs 805-10-55-5D through 55-5E, the presence of more than an insignificant amount of goodwill may be an indicator that the acquired process is substantive and, therefore, the acquired set is a business. However, a business need not have goodwill.

Overview

In Step 2, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. The guidance provides a framework to assist entities in evaluating whether both an input and a substantive process are present and gives examples about applying the implementation guidance.

The first decision point is to determine if the set has outputs. The guidance has a different set of criteria depending on whether the set has outputs. Outputs are the result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (e.g. dividends, interest), or other revenues. Although outputs are not required for a set to be a business, outputs are one of the three elements of a business. The FASB created a more stringent set of criteria when outputs are not present.

**Step 2: Evaluate whether an input and a substantive process exist:
Does the set have outputs?**

No

The set is a business if it includes:

— Employees that form an organized workforce with skills, knowledge, or experience to perform an acquired process (or group of processes) that is critical to the ability to create outputs; *and*
— Inputs that the workforce could develop or convert into outputs.

Yes

The set is a business if it includes an input or inputs and:

— An organized workforce with skills, knowledge, or experience critical to continue producing outputs;
— An acquired contract that is in effect an organized workforce critical to continue producing outputs;
— A process (or group of processes) that cannot be replaced without significant cost, effort, or delay; or
— A process (or group of processes) that is considered unique or scarce.

Determining whether one or more inputs exist is usually straightforward. Accordingly, the discussion below focuses primarily on determining whether a substantive process exists.

4.1 Acquired set with no outputs

For a set with no outputs (e.g. an entity in the development stage that has not generated revenues) to have **both** an input and substantive process, it must include: [805-10-55-5D]

— employees that form an organized workforce; and
— an input that the workforce could develop or convert into outputs.

The employees that form the organized workforce must have the necessary skills, knowledge or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs.

Organized workforce

The organized workforce must consist of employees. An acquired contract that performs a process would not on its own be considered an organized workforce when a set does not have outputs. However, if the set includes both employees and service contracts, the processes performed by the vendor may be considered a critical process.

Excerpt from ASU 2017-01

BC48 The Board also noted that a critical process performed by employees could include the management of service providers. The Board stated that, as an example, an entity should come to consistent conclusions when evaluating a set that has 100 employees and a set that has 20 employees with the equivalent of 80 employees replaced by outsourced service providers because the 20 employees would be responsible for the management and performance of the outsourced employees.

A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all the processes required to create outputs. However, no further guidance was provided and as a result, determining whether the acquired workforce is performing a critical process will require significant judgment.

We believe the analysis of whether the process is critical should focus on the nature of the process being performed by the workforce. To evaluate whether the process is critical or minor, entities may compare the process being performed by the workforce to the 'missing processes' from the set. If the acquired process (or group of processes) is considered qualitatively and quantitatively minor compared to all of the processes required to produce outputs, the process would not be critical.

The following factors may indicate that the employees are performing a process that is critical to developing or converting inputs into outputs (none of which individually would be determinative):

— **Size of the workforce.** The greater the number of employees, the more likely the process is substantive. However, the number of employees is not determinative as a few employees might have significant knowledge, experience or skills that are critical to developing the acquired inputs into outputs.

— **Stage of activities.** If the organized workforce has not yet commenced activities to develop or convert inputs into outputs, it could call into question whether the processes acquired are in fact substantive or could be used to develop or convert the inputs into outputs. In contrast, if the organized workforce has commenced key activities to develop or convert inputs into outputs, the processes being performed would likely be critical.

— **Research and development activities.** The process may be substantive if the organized workforce has employees with necessary skills, knowledge or experience in performing research and development processes that are significant to converting inputs into outputs. In an entity without outputs, research and development activities are likely to be one of an entity's most significant processes in the development stage. Example 13 below illustrates where research and development processes performed by acquired scientists are critical to the development of intellectual property. [805-10-55-70 – 55-72]

— **How close the set is to generating revenues.** If the entity is close to generating revenues, the processes the employees are performing are more likely to be critical to developing or converting the inputs into outputs. The workforce may not be critical if there is significant uncertainty about its knowledge, skills, experience or ability to complete the required steps to turn the inputs into outputs. For example, the need to hire a significant number of employees after the acquisition with the necessary knowledge, skills or experience to continue the activities required to develop or convert the acquired inputs into outputs could indicate that the processes performed by the acquired workforce are not critical.

— **Whether the set is self-sustaining and operated on a stand-alone basis.** If the set includes an organized workforce that was operating the set on a stand-alone basis (i.e. it was not a division, subsidiary, product line or portion of a larger entity), the organized workforce may be performing critical processes to manage and operate the set. This factor does not refer to the entity's financing needs or ability to access capital.

— **Presence of goodwill.** The presence of goodwill in a set with no outputs may indicate that the organized workforce is performing a critical process.

— **Process of integrating multiple assets.** If the employees are performing resource allocation, strategic management or operational processes that manage different risks to integrate multiple different assets to develop inputs into outputs, the process is likely critical.

Inputs that the entity could convert into outputs

Acquiring employees is not enough to conclude that a set with no outputs is a business. That acquired workforce must be able to develop or convert another acquired input or inputs into outputs. As a result, the set also must include an input or inputs that could be developed or converted (or are being developed or converted) into outputs. These inputs include but are not limited to items such as technology, drug compounds, real estate, oil and gas properties and distribution or production rights.

These types of assets form the foundation of what would ultimately be the goods or platform for the services to be provided to customers. Assets such as equipment that could be used to convert other inputs (e.g. a piece of machinery used to manufacture a good) may not be sufficient on their own because those inputs generally are not developed or converted into outputs and are used only to convert another input into outputs.

Example 12
Acquisition of a drug candidate – Scenario 1[2]

Facts

— Pharma Co. acquired two development stage drug compounds from Biotech that treat different illnesses.
— The two drug compounds each have significant value and significantly different risks (e.g. they treat different illnesses, have different patient subsets and have different expected lives).
— Pharma Co. also assumes from Biotech their (1) clinical research organization (CRO) contract and (2) clinical manufacturing organization (CMO) contract.
— Pharma Co. does not acquire the scientists and long-lived tangible assets.
— Biotech is not currently generating revenues.

[2] Based in part on Case B, Scenario 2, in ASU 2017-01

Analysis

Step 1 (screening test)

Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable assets. Pharma Co. notes that the nature of the IPR&D activities is similar. However, Pharma Co. concludes that each activity has significantly different risks associated with creating outputs because each activity has different risks associated with developing and marketing the compound to customers.

Pharma Co. also concludes that there is no fair value associated with the CRO and CMO contracts because the services are provided at market rates and could be provided by multiple vendors. Therefore, all of the consideration in the transaction will be allocated to the IPR&D activities.

The fair value of the gross assets is spread across the two identifiable IPR&D assets because these assets are not similar for the purposes of applying the screening test. Step 1 is not met.

Step 2 (input and substantive process)

When there are no outputs, there must be inputs and employees (an acquired contract that represents an organized workforce is not sufficient). Accordingly, the acquired CRO and CMO contracts are not relevant to the Step 2 analysis because there are no outputs in the set. Pharma Co. concludes that the criteria to determine whether the set has both an input and a substantive process are not met because the set does not have employees.

Conclusion

The acquired set is not a business because the set does not include employees that represent an organized workforce with the necessary skills, knowledge or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs.

Example 13
Acquisition of a drug candidate – Scenario 1[3]

Facts

- Pharma Co. acquires the outstanding shares of Biotech, whose operations include IPR&D activities on several development stage drug compounds. The compounds target different illnesses and patient subsets.
- Pharma Co. also acquires long-lived tangible assets such as a corporate headquarters, a research lab and testing equipment.
- Pharma Co. concludes there is significant fair value in the acquired workforce, the different IPR&D projects and tangible assets.
- The set includes the scientists with the necessary skills, knowledge or experience to continue to perform R&D activities.

[3] Based in part on Case C in ASU 2017-01

— There is also a more-than-insignificant amount of goodwill.
— Biotech has not generated revenues.

Analysis

Step 1 (screening test)

Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable assets. Pharma Co. notes that the nature of the IPR&D activities is similar. However, Pharma Co. concludes that each activity has significantly different risks associated with creating outputs because each activity has different risks associated with developing and marketing the compound to customers.

In addition, there is significant fair value in different asset classes: intangible (IPR&D assets) and tangible (the headquarters, the research lab and testing equipment). Step 1 is not met.

Step 2 (input and substantive process)

When there are no outputs, there must be inputs and employees. Pharma Co. concludes that the scientists make up an organized workforce that has the necessary skills, knowledge or experience to perform R&D processes. Those processes, when applied to the IPR&D inputs, are critical to the ability to develop the inputs into outputs.

There is also a more-than-insignificant amount of goodwill, which indicates the workforce is performing a critical process.

Conclusion

The acquired set is a business because the set includes employees that represent an organized workforce with the necessary skills, knowledge or experience to perform an acquired process that when applied to the acquired inputs (IPR&D) is critical to the ability to develop those inputs into outputs.

4.2 Acquired set with outputs

When the set has outputs, only one of the following factors needs to be present for a set to have a substantive process. The set will have both an input and a substantive process when **any** of the following are present:

— Employees that form an organized workforce with the necessary skills, knowledge or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs;

— An acquired contract that provides access to an organized workforce with the necessary skills, knowledge or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs;

— The acquired process (or group of processes) when applied to an acquired input or inputs 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; or

— The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and is considered unique or scarce.

The FASB's guidance does not specifically state what inputs must be acquired because by definition a set that has outputs would have an input (or inputs) that could be converted into outputs. However, the process acquired must relate to an acquired input because all of the factors require that the process acquired be applied to an input in the acquired set. [805-10-55-5E]

Organized workforce consisting of employees

Similar to sets with no outputs, a set that has outputs is a business when it includes an organized workforce that consists of employees that have the necessary skills, knowledge or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs are critical to the ability to continue producing outputs. While employees are an input, they can also provide a process (see section 2) if they constitute an organized workforce. However, to be a business, we believe the workforce must perform a process on another acquired input. That is, the employees cannot be the only input in the set.

An entity would perform a similar evaluation of whether the acquired process (employees that make up an organized workforce) is critical as it would if the set did not have outputs (see section 4.1). However, the focus of the analysis is on whether that process is critical to the continuation of outputs. The following factors may indicate that the acquired process is considered critical:

— **Involvement in fulfillment activities.** If the workforce is directly involved in fulfillment of providing goods or services or obtaining customers, that would indicate that the acquired process is critical to continuing to produce outputs. For example, an entity acquires a set with a workforce that is directly involved in generating new customers, producing goods sold (manufacturing employees) or fulfilling a service to the customers (customer-facing employees providing the service).

— **Skillset of the workforce.** If the workforce has specialized skills or knowledge required to perform operational processes needed to continue producing outputs, that would be an indicator that the workforce is critical. The specific skills of the workforce must be considered in light of the set's activities. For example, a group of cleaning employees might be very skilled at cleaning; however, if the business activities of the set are not cleaning services, they usually would not be performing a process that is critical to continuing to produce outputs.

— **Size of the workforce.** The greater the number of employees the more likely the process is to be substantive. However, the number of employees is not determinative because a few employees might have significant knowledge, experience or skills that are critical to continuing to produce outputs.

— **Ability to operate on a stand-alone basis.** If the set includes an organized workforce that was operating the set on a stand-alone basis (i.e. it was not a division, subsidiary, product line or portion of a larger entity), the organized workforce may be performing processes critical to continuing to produce outputs. This factor does not refer to the entity's financing needs or ability to access capital.

— **Presence of goodwill.** The presence of goodwill may indicate that the organized workforce is performing a critical process.

— **Strategic management process.** If the processes performed are strategic management processes that involve determining the strategy for creating outputs, setting the price with customers or determining the types of goods or services to sell to customers, that may indicate that the acquired processes are critical.

— **Resource allocation process.** If the organized workforce is performing resource allocation processes to facilitate the delivery of goods or services to customers, these processes may be critical to continue producing outputs.

— **The number of processes acquired.** While only a single substantive process is required for a set to be a business, the more processes the organized workforce is performing, the more likely the group of processes together would be considered critical.

— **Process of integrating multiple assets.** If the process acquired includes resource allocation, strategic management or operational processes that manage different risks to integrate multiple different assets to continue producing outputs, those processes would likely be considered critical.

Acquired contracts

In contrast to sets that **do not** have outputs, entities must evaluate acquired contracts (when the set is receiving goods or services) to determine if the entity in effect acquired an input or an organized workforce performing a substantive process.

Excerpt from ASU 2017-01

BC46 The Board concluded that the assessment of a contractual arrangement, such as a supply agreement, should be relatively straightforward, meaning those contracts would likely be inputs because the supplier is not applying a process to another input in the set. However, the Board rejected the view that a service provided through a contractual arrangement should never indicate that a substantive process was acquired. The Board observed that there are many industries in which operating activities are outsourced, and the activities performed by a service provider may not be significantly different than the activities that would be performed by employees. The Board acknowledges that in some circumstances, whether an organized workforce accessed through a contractual arrangement performs or provides a process could be subjective and the critical factor to determining whether a set is a business.

A typical supply agreement is an input. However, when the vendor provides a service, the vendor could be applying a process to an input for the set. For example, the service provider in an asset management contract typically applies processes to the investment portfolio and customer contracts to raise and deploy capital to create outputs. As a result, similar to employees, an acquired service contract could be both an input and a process. [ASU 2017-01.BC Case F, 805-10-55-82 – 55-84]

When the set includes a service contract, entities will need to make an evaluation similar to evaluating an employee workforce to identify the processes that are performed in the contract and whether that process (or group of processes) is critical to continue producing outputs. However, we believe there should be more scrutiny applied to conclude that an acquired service contract represents a substantive process when a set does not include employees.

The inherent limitations of what may be performed by an acquired contract requires an entity to analyze the substance of the acquired contract to determine if in effect it has acquired an organized workforce. As a result, the guidance requires that entities should also consider the duration and renewal terms of the acquired contract when making this determination. The FASB did not provide additional guidance on how to evaluate the duration or renewal options; however, we believe the objective is to determine whether the entity acquired a substantive process (through the contract) or whether the contract is in substance an input.

The nature of an acquired organized workforce is such that an entity obtains the employees' knowledge and skills and therefore acquires a process that can be passed along to other employees. As a result, the entity controls the process and can sustain it even after termination of an individual employee. In contrast, if a service contract is not renewed or was cancelled, the process may be terminated or need to be replaced. As a result, if a contract has a long duration, the substance of the acquisition may be more akin to acquiring an organized workforce and process that the entity effectively controls.

We believe that if the services contract is for a short duration (e.g. less than one year with no explicit or implicit renewal options), generally the contract would not provide an organized workforce performing a critical process. In contrast, a service contract with a term greater than one year should be evaluated to determine whether the process being performed is critical, similar to the evaluation for an employee workforce. However, one year should not be viewed as a bright line.

When considering short-term contracts with a renewal option (or long-term contracts with termination provisions akin to a renewal), further consideration is needed. The following factors may indicate that a service contract with renewal periods that extend beyond one year is akin to acquiring an organized workforce:

— the services are proprietary or not easily accessible in the marketplace. If the services are not readily available in the marketplace, it may indicate that the acquired contract is a substantive process that is critical to continue producing outputs; or
— replacing the service provider would result in a significant cost, effort or delay in the ability to continue producing outputs.

However, if the services are provided only on a temporary basis, or if the services are merely meant to help the acquirer transition on a temporary basis, that would indicate that in substance the entity did not acquire an organized workforce that is critical to continuing to produce outputs. This is different from acquiring an organized workforce that has a going concern element (even if the entity planned to terminate the employees).

Because the assessment of whether the set is a business is made from the perspective of a market participant, it is not relevant whether the acquirer plans on terminating the contract.

Acquired process cannot be replaced without significant cost, effort or delay, or is considered unique or scarce

An organized workforce is not required when outputs are present. The FASB decided that an organized workforce might not be required if the set includes automated processes (e.g. through acquired technology, infrastructure or specialized equipment) or other significant processes that significantly contribute to the ability to continue producing outputs. The FASB's guidance addresses the scenarios when a set would have a substantive process but no workforce. [805-10-55-5E(c) – 55-5E(d)]

A substantive process could also be present when the process would significantly contribute to the ability to create outputs and **either**:

- the acquired process (or group of processes) cannot be replaced without significant cost, effort or delay in the ability to continue producing outputs; or
- is considered unique or scarce.

Examples include:

- a manufacturing process included in an assembly line that is highly automated;
- a process embedded in the setup of the infrastructure that requires minimal involvement from employees to complete;
- proprietary production techniques; and
- technology that performs processes to fulfill contracts with customers.

4.3 Revenue or lease contracts

While service contracts might provide access to an organized workforce performing a substantive process, a revenue contract, lease arrangement (the acquiree is the lessor) or other similar contracts should be excluded from the evaluation of whether a substantive process is present. As a result, an entity would not be able to conclude that it acquired a process solely because a revenue or lease contract was present. [805-10-55-5F]

4.4 Presence of goodwill

The presence of more than an insignificant amount of goodwill indicates that an acquired process is substantive. However, the presence of goodwill does not always mean a process is present. The entity should not assume that a process was acquired because of goodwill. Rather, the entity would first need to identify the acquired process (and the organized workforce performing that process if the set does not have outputs) and then it could use the presence of goodwill to help evaluate whether the process is substantive.

One of the components of goodwill is usually the value of the assembled workforce. As a result, fair value associated with a workforce may indicate that an organized workforce is performing a critical process. Similarly, the excess of fair value over the net assets acquired could also indicate that there is value in an acquired process that would typically not be an identifiable asset.

Whether an entity records goodwill depends on the transaction being a business combination. As a result, for purposes of this analysis (i.e. to determine if a transaction is a business combination), the evaluation would focus on whether the consideration transferred was in excess of the fair value of the identifiable net assets acquired.

4.5 Market participant concept

The evaluation of whether the acquired assets and activities constitute a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. It does not matter how the seller used, or acquirer plans to use, the set when evaluating whether the set is a business. [805-10-55-8]

For example, an entity may acquire a division from a seller of a vertically integrated business. Because that set was operated by the seller, the division did not have external customers; it only transferred goods to other divisions of the seller – e.g. intercompany transfers. After the transaction, the former division would transfer the same goods to its former parent, although those sales would be recorded as revenue. When viewing this set from the standpoint of a market participant, that set would have outputs and the acquirer would need to evaluate whether both an input and substantive process was acquired following the appropriate guidance.

Similarly, an entity might acquire a supplier even though the entity was that supplier's only customer to more effectively manage its supply chain. It would not be relevant how the acquirer intended to use the set when viewing the set from the standpoint of a market participant. From the standpoint of a market participant, that set would have outputs (even if post-transaction the goods or services are provided only to internal divisions of the acquirer) and the acquirer would need to evaluate whether both an input and substantive process was acquired following the appropriate guidance.

The evaluation of whether the criteria were met should occur from a market participant's perspective. This may affect the conclusion on whether a process is critical to the creation of outputs. A process that is not critical to a specific acquiree that already has the same process in place may nevertheless be critical to a market participant as that term is defined in Topic 805.

For example, Company A acquires a set that includes processes to produce a unique type of computer monitor that Company A already produces. Company A acquired the set to take its competitor out of the market, because Company A and the competitor are the only ones that currently produce the item. While the process to create the unique computer monitor is not critical (or unique) to Company A, the process to produce this item may be critical (or unique) to a market participant and must be evaluated from that perspective when evaluating whether a business was acquired.

Example 14

Acquisition of real estate[4]

Facts

- REIT acquires 10 single-family homes, which have significant value in the aggregate, in the Washington, DC metro area. The acquisition includes the land, building, property improvements and in-place leases.
- Each single-family home has a different layout (e.g. floor plan, square footage and design). The lessees are a similar class of customers.
- REIT also acquires an office park with six 10-story office buildings leased to maximum occupancy, which have significant value in the aggregate.
- REIT acquires the vendor contracts for outsourced cleaning, security and maintenance.
- Seller's employees that perform leasing (sales, underwriting, etc.), tenant management, financing and other strategic management processes are not included in the set.
- No other assets are acquired in the transaction.

Analysis

Step 1 (screening test)

REIT chooses to perform the screening test qualitatively because it is clear that substantially all of the fair value of the gross assets is not concentrated in a single asset or group of similar assets. This is because there is significant value in the 10 single-family homes and six 10-story office buildings.

The single-family homes and office buildings are in a different class of tangible assets, and managing those assets (and producing outputs) has significantly different risks. Step 1 is not met.

Step 2 (input and substantive process)

The set has outputs as a result of the continuing lease income from in-place leases on the properties acquired. Accordingly, REIT evaluates the factors when a set has outputs.

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[4] Based in part on Case A, Scenario 2, in ASU 2017-01

The set does not include employees but does include acquired service contracts (e.g. contracts for outsourced cleaning, security and maintenance). The acquired service contracts are not substantive as the processes performed are not critical to continue producing outputs (lease income). The functions of cleaning, security and maintenance do not generate substantive income in the real estate industry. These functions may be substantive in other industries, but are not in the real estate industry.

The leases are excluded from the analysis of whether a process was acquired. There is no substantive process acquired in the set and Step 2 is not met.

Conclusion

The set does not include a substantive process and is therefore not a business.

Example 15

Acquisition of loan portfolio – Scenario 1 (continued)[5]

Facts

- Bank A acquires a portfolio of residential mortgages and a portfolio of commercial mortgages, each having significant value and significantly different risks (e.g. term, size and risk ratings).
- Bank A does not acquire the employees that managed the credit risk of the loan portfolios and had relationships with the borrowers in the acquisition. Bank A does not acquire other protocols, conventions or systems.
- The loan portfolios currently produce outputs (interest income).

Analysis

Step 1 (screening test)

As described in Example 10, the fair value of the gross assets is spread across the two identifiable assets (loan portfolios); therefore, Step 1 is not met.

Step 2 (input and substantive process)

The set has outputs as a result of the continuing interest income from the loans acquired. Accordingly, Bank A evaluates the factors when a set has outputs.

The loans are excluded from the analysis of whether a process was acquired. The set does not include an organized workforce or an acquired process. Step 2 is not met.

Conclusion

The set does not include a substantive process and is therefore not a business.

[5] Based in part on Case H, Scenario 2, in ASU 2017-01

Example 16
Acquisition of loan portfolio – Scenario 2[6]

Facts

- Bank A acquires from Bank Z a portfolio of residential mortgages and a portfolio of commercial mortgages, each having significant value and significantly different risks (e.g. term, size and risk ratings).
- The set includes the employees of Bank Z that managed the credit risk of the portfolio and the relationship with the borrowers (such as brokers and risk managers).
- There is a more-than-insignificant amount of goodwill.
- The loan portfolios currently produce outputs (interest income).

Analysis

Step 1 (screening test)

Bank A concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable asset(s). This is because the two loan portfolios have significantly different risk characteristics and are not similar assets.

The fair value of the gross assets is spread across the two identifiable assets (loan portfolios) because these assets are not similar for the purposes of applying the screening test. Bank A also concludes that there is a more-than-insignificant amount of goodwill associated with the acquired workforce, which affects the gross assets acquired (e.g. the denominator). Step 1 is not met.

Step 2 (input and substantive process)

The set has outputs as a result of the continuing interest income from the loans acquired. Accordingly, Bank A evaluates the factors when a set has outputs.

The set includes an organized workforce that performs processes (customer relationship management and credit risk management) critical to the ability to continue producing outputs. The fact that there is a more-than-insignificant amount of goodwill acquired indicates the acquired workforce is performing a substantive process critical to continue producing outputs. Step 2 is met.

Conclusion

The acquired set is a business because the set includes both an input and a substantive process that together significantly contribute to the ability to continue producing outputs.

6 Based in part on Case H, Scenario 3, in ASU 2017-01

Example 17
Acquisition of brands – Scenario 1[7]

Facts

- MSZ Corp. acquires:
  - the rights to Yogurt Brand F, including all related intellectual property;
  - all customer contracts and relationships, finished goods inventory, marketing materials, customer incentive programs and raw material supply contracts; and
  - the specialized equipment specific to manufacturing Yogurt Brand F, and documented processes and protocols to produce Yogurt Brand F.
- MSZ Corp. does not acquire employees, manufacturing facilities, non-specialized manufacturing equipment and processes required to produce the product and distribution facilities (and related distribution processes).
- There is a more-than-insignificant amount of goodwill.
- The set currently produces outputs (Yogurt Brand F).

Analysis

Step 1 (screening test)

The gross assets include intellectual property (trademark, related trade name and recipes) associated with Yogurt Brand F, customer contracts and related relationships, equipment, finished goods inventory and the excess of the consideration transferred over the fair value of the net assets acquired.

There is significant fair value in both tangible and intangible assets. MSZ Corp. 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 even though, for purposes of the analysis, the intellectual property is considered to be a single identifiable asset. Step 1 is not met.

Step 2 (input and substantive process)

As a part of Step 2, MSZ Corp. notes that the set has outputs through the continuation of revenues. MSZ Corp. determines that the set does not include an organized workforce or an acquired contract that is in effect an organized workforce. However, the acquired manufacturing processes are unique to Yogurt Brand F, and when those processes are applied to acquired inputs such as the intellectual property, raw material supply contracts and the equipment, they significantly contribute to the ability to continue producing outputs. The set includes both inputs and substantive processes. Step 2 is met.

Conclusion

The acquired set is a business because the set includes inputs and substantive processes that together significantly contribute to the ability to continue producing outputs.

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7 Based in part on Case G in ASU 2017-01

Example 18
Acquisition of oil and gas properties – Scenario 2

Facts

- XYZ Co. buys all the outstanding shares of Entity A that owns and operates a number of diverse oil and gas properties (both proved and unproved properties).
- XYZ Co. acquires the employees and all of the assets including the long-lived tangible assets of Entity A.
- There is significant fair value in the acquired workforce, production processes, the oil and gas properties and other tangible assets.
- Entity A is currently generating revenues.

Analysis

Step 1 (screening test)

XYZ Co. first needs to determine whether Step 1 is met. XYZ Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or a group of similar identifiable assets.

This is because there is significant fair value in many different asset classes including intangible assets such as the acquired workforce and production processes (both of which are included in goodwill for the screening test), and tangible assets including the oil and gas properties (both proved and unproved properties) and other tangible assets. Step 1 is not met.

Step 2 (input and substantive process)

XYZ Co. concludes that the employees make up an organized workforce that has the necessary skills, knowledge or experience to perform oil and gas processes. The oil and gas production processes cannot be replaced without significant cost, effort or delay. Those processes are applied to the oil and gas properties inputs and are critical to the ability to turn the inputs into outputs.

There is also a more-than-insignificant amount of goodwill, which indicates the workforce is performing a critical process. XYZ Co. concludes the set includes inputs and substantive processes and is therefore a business. Step 2 is met.

Conclusion

The acquired set is a business because the set includes inputs and substantive processes that together significantly contribute to the ability to create outputs.

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