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Defining Issues®

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Contents

FASB Clarifies the Definition of a Business

The FASB recently issued an Accounting Standards Update (ASU) that provides a new framework for determining whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses.[1]

Key Facts

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 an initial screening 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).

Step 1 — **Is substantially all of the fair value of the gross assets acquired concentrated in a single (group of similar) identifiable asset(s)?**

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

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

If yes…	**If no…**
The set is a business if it includes an input or inputs and: • Organized workforce with skills, knowledge, or experience critical to continue producing outputs; • Process that cannot be replaced without significant cost, effort, or delay; **or** • Process that is considered unique or scarce.	The set is a business if it includes: • 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** • Input(s) that the workforce could develop or convert into outputs.

Key Impact

Fewer transactions are expected to involve acquiring or selling a business. Real estate and life sciences industries likely will be most affected.

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[1] FASB Accounting Standards Update No. 2017-01, Clarifying the Definition of a Business, January 5, 2017, available at www.fasb.org.

Scope broader than acquisitions

Even though the ASU updates guidance on business combinations, the definition of a business affects many areas of accounting and financial reporting, including acquisitions and disposals, goodwill, and variable interest entity consolidation requirements.

Why Does the Definition of a Business Matter?

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

Group of Assets	Business
Initial Measurement	
Purchase price allocated on a relative fair value basis. 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.
Direct Acquisition Related Costs	
Capitalized and included in purchase price.	Generally expensed as incurred.
Bargain Purchase Amount	
Allocated to identifiable nonfinancial assets and liabilities on a relative fair value basis.	Recognized immediately in earnings as a gain.
Contingent Consideration	
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, measured at fair value. Subsequent changes to the fair value of liability-classified contingent consideration are recognized in earnings.
In-process Research and Development (R&D)	
Purchase price allocated to in-process R&D and expensed unless it has an alternative future use.	Capitalized at fair value and accounted for as an indefinite-lived intangible asset until completion or abandonment of the project.

KPMG Observations

An entity is required to allocate consideration to intangible assets in an asset acquisition and a business combination. For example, an entity would allocate the purchase price between the in-place leases and tangible real estate assets in an asset acquisition and a business combination. The fact that goodwill cannot be recognized in an asset acquisition emphasizes the importance of undertaking a rigorous process to identify and properly value all assets, including intangible assets, within the group of assets acquired.

Real estate will typically be considered a single asset

In Step 1, a single identifiable asset generally would include an identifiable asset or group of assets that could be recognized and measured as a single identifiable asset in a business combination.

However, the FASB made two exceptions in which a company should combine separately identifiable assets into a single asset (1) certain tangible assets attached to each other that cannot be removed without significant cost or diminution in utility or fair value and (2) in-place lease intangibles, including favorable and unfavorable lease assets and liabilities, and the related leased assets.

Examples That Illustrate the Definition

Example 1: Real Estate[2]

Facts

- REIT acquires 10 single-family homes in the Washington, D.C. 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.
- No workforce or other assets are acquired in the transaction.

Analysis

Step 1

REIT identifies the single assets in the set and concludes that the land, building, property improvements, and in-place leases at each property are considered a single asset. The building and property improvements are attached to and cannot be physically removed and used separately from the land without incurring significant costs or reducing their fair value. The in-place lease intangibles for each home are required to be combined with the leased asset for the screening test.

REIT concludes that the 10 homes are a group of similar assets based on the nature of the homes (single-family) and similar risks associated with managing this portfolio of homes. That is, the risks of operating the homes and managing the tenants are not significantly different.

Because there are no other assets in the set, REIT concludes that the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets (the 10 homes) and Step 1 is met.

Step 2

Step 2 is not necessary.

Conclusion

The acquired set meets the initial screening test (Step 1). Therefore, the acquired set is not a business.

KPMG Observations

To be a business, a set does not need all of the inputs and processes required to create outputs, but it must include an input and substantive process.

The ASU eliminates the requirement in current U.S. GAAP to evaluate whether a market participant could replace missing inputs and processes. This requirement led to a broad interpretation of the definition of a business, which in some cases resulted in transactions similar to Example 1 being considered a business. The ASU requires entities to focus on the substance of what was acquired in the set, rather than what can be replaced.

[2] Based on Case A, Scenario 1, in the ASU.

The existence of outputs does not automatically mean that the set is a business

A continuation of revenues would not, on its own, indicate that a company acquired a substantive process (see Example 2).

Under the ASU, an acquired contractual arrangement that provides for the continuation of revenues (e.g., customer contracts or leases) would be excluded from the analysis of whether there is a substantive process. An entity must identify another substantive process in the set to conclude that the set is a business.

Example 2: Banking[3]

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

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. Step 1 is not met.

Step 2

Bank A concludes that the acquisition has outputs (interest income from the loan portfolios). However, Bank A concludes that the set includes neither an organized workforce nor an acquired process.

Conclusion

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

KPMG Observations

Evaluating whether assets are similar for purposes of Step 1 will require significant judgment. The FASB clarified in the ASU that assets with significantly different risks should not be considered similar, and provided examples using the life sciences, real estate, and banking industries.

In Example 2, the loan portfolios are not considered similar due to significantly different risk characteristics. The ASU also states that certain types of assets should not be considered similar: tangible and intangible assets (except as previously described for leased property and related intangibles); intangible assets in different major intangible asset classes; financial and nonfinancial assets; different major classes of financial assets; and different major classes of tangible assets.

[3] Based, in part, on Case H, Scenario 2, in the ASU.

Employees are required for a set with no outputs to be a business

The FASB clarified in the ASU that when a set does not have outputs, it must have employees to conclude that the organized workforce is performing a substantive process and that the set is a business. A process performed by a service provider through a contract would not be sufficient.

In contrast, when a set has outputs, an entity also would need to assess acquired contracts to determine whether it has effectively acquired an organized workforce that is performing a substantive process.

Example 3: Life Sciences[4]

Facts

- Pharma Co. buys the outstanding shares of Biotech, whose operations include R&D activities on several development stage drug compounds (in-process R&D projects). The compounds target different illnesses and patient subsets.
- Pharma Co. acquires the scientists who have the necessary skills, knowledge, or experience to continue to perform R&D activities, as well as long-lived tangible assets such as corporate headquarters, a research lab, and testing equipment.
- Pharma Co. concludes there is significant fair value in the acquired workforce, the different in-process R&D projects, and tangible assets.
- Biotech has not generated revenues.

Analysis

Step 1 Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single or group of similar identifiable asset(s).

It bases its conclusion on the fact that there is significant fair value in many different asset classes: tangible (the corporate headquarters, the research lab, and testing equipment) and intangible (the in-process R&D projects and the acquired workforce).

Step 2 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 are applied to the in-process R&D inputs and are critical to the ability to develop the inputs into outputs. There is also a more-than-insignificant amount of goodwill (fair value associated with the workforce) identified, which is an indicator that the workforce is performing a substantive process.

Conclusion

The set includes inputs and substantive processes and is a business.

KPMG Observations

The presence of goodwill may be a significant factor in determining whether the set is a business. For purposes of Step 1, gross assets acquired include any consideration in excess of the fair value of net identifiable assets acquired (e.g., goodwill, which includes the value of an acquired workforce). If the excess is significant, it would prevent the transaction from passing Step 1. The presence of more than an insignificant amount of goodwill may indicate that an acquired process is substantive.

[4] Based on Case C in the ASU.

The IASB proposed to make similar amendments

The FASB received feedback that the current converged definition of a business is applied differently under U.S. GAAP and IFRS. The FASB narrowed the definition and expects that practice under U.S. GAAP and IFRS will be more closely aligned.

The IASB received feedback on its definition of a business that was similar to the feedback that the FASB received. To address the feedback, the IASB issued an exposure draft in June 2016 that is similar to the FASB's ASU.

Effective Dates and Transition

	Public Business Entities	All Other Entities
When is the ASU effective?	Annual and interim periods in fiscal years beginning after **12/15/2017**	Annual periods in fiscal years beginning after **12/15/2018**, and interim periods in fiscal years beginning after **12/15/2019**
May entities early adopt?	Entities may early adopt the ASU and apply it to transactions that have not been reported in financial statements that have been issued or made available for issuance. No transition disclosures are required.	

An entity could early adopt the ASU at the beginning of a reporting period for which financial statements have not been issued or made available for issuance. For example, a calendar-year-end SEC registrant that has not issued its 2016 Form 10-K may adopt the amendments in the fourth quarter of 2016, but would be allowed to apply the amendments beginning on October 1, 2016 only. A calendar-year-end nonpublic business entity that has not released interim or annual financial statements for 2016 would be able to apply the amendments as of January 1, 2016.

The ability to adopt this ASU as of the beginning of a reporting period, including interim periods, may result in different conclusions for similar transactions in the same annual reporting period.

Next Steps

The ASU marks the completion of the first phase of the FASB's project on the definition of a business. Phase II relates to the derecognition of nonfinancial assets (including partial sales). In Phase III the Board will consider aligning the accounting for business combinations and asset acquisitions. An ASU for Phase II is expected in January 2017.[5] The FASB has not yet begun deliberations on Phase III.

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Earlier editions are available at: kpmg.com/us/frn

[5] FASB Proposed Accounting Standards Update, Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets, June 6, 2016, available at www.fasb.org.