Centri's Focus On: **FASB**

FASB CLARIFIES THE DEFINITION OF A BUSINESS

Details

The FASB recently issued ASU 2017-01 to clarify the definition of a business, which is fundamental in the determination of whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses in accordance with ASC 805, Business Combinations. This determination is important given the diverging accounting models used for each type of transaction. The guidance is generally expected to result in fewer transactions qualifying as business combinations. The ASU becomes effective in 2018 for public entities and is available at here.

Overview

Under the current implementation guidance in ASC 805, there are three elements of a business – inputs, processes, and outputs. While an integrated set of assets and activities (collectively referred to as a "set") that is a business usually has outputs, outputs are not required. In addition, under current guidance, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs, for example, by integrating the acquired set with their own inputs and processes. This led many transactions to be accounted for as business combinations rather than asset purchases under legacy GAAP. The primary goal of ASU 2017-01 is to narrow the definition of a business.

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Main Provisions

Under the ASU, the revised definition of a business consists of the following key concepts:

- 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. (Par. 805-10-55-3A)
- To be capable of being conducted and managed for the purposes described above, 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. (Par. 805-10-55-5)

Importantly, the ASU also introduces a “screen” to assist entities in determining when a set should not be considered a business. 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. The ASU includes practical guidance on what to include in gross assets and what constitutes a single identifiable asset or a group of similar identifiable assets in the context of applying the screen.

If the screen is not met, the ASU requires that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output. Further, the ASU removes the evaluation of whether a market participant could replace missing elements (as required under current GAAP).

The ASU provides a framework for determining whether the set includes both an input and a substantive process (and thus, should be considered a business). Under the framework, the criteria to consider depend on whether a set has outputs. The ASU narrows the definition of the term output such that it is consistent with how outputs are described in Topic 606, Revenue from Contracts with Customers. That is, an output is 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.

Transactions Involving Sets without Outputs

Although outputs are not required for a set to be a business, outputs generally are a key element of a business; therefore, the ASU introduces more stringent criteria for sets without outputs. A set that does not have outputs is considered to 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 with the necessary skills, knowledge or experience to perform an acquired process, and an input that the workforce could develop or convert into output. In other words, the presence of an outsourced workforce arrangement is not sufficient to conclude that a substantive process has been acquired. The ASU provides factors to consider when determining whether the acquired workforce is performing a substantive process.

Transactions Involving Sets with Outputs

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. When the set has outputs, 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.
b. An acquired contract that provides access to an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process. An entity should assess the substance of an acquired contract and whether it has effectively acquired an organized workforce that performs a substantive process.
c. The acquired process(es) 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(es) significantly contributes to the ability to continue producing outputs and is considered unique or scarce.

Centri's Insights

Many common transactions that have historically been considered business combinations will now be accounted for as asset acquisitions due to the introduction of the screen. In particular, the real estate, pharmaceutical, biotechnology and financial industries may be significantly impacted, as illustrated in the multiple examples included in new paragraphs 805-10-55-51 through 55-96.

Although the ASU revises the definition of a business, the recognition and measurement guidance for business combinations and asset acquisitions remains the same. Consequently, the accounting treatment for transaction costs, contingent consideration, and several other items will continue to differ based on whether an acquired set constitutes a business or not. In this context, the FASB is planning to consider whether accounting differences for acquisitions (or disposals) of a business and assets can be aligned in a future-standard setting project.

Effective Date and Transition

The amendments are effective prospectively for public business entities for annual periods beginning after December 15, 2017, including interim periods within those periods. The amendments are effective prospectively for all other entities for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning December 15, 2019. Early adoption is permitted as follows:

- For transactions for which the acquisition date occurs before the issuance date or effective date of the amendments, only when the transaction has not been reported in financial statements that have been issued or made available for issuance.

- For transactions in which a subsidiary is deconsolidated or a group of assets is derecognized that occur before the issuance date or effective date of amendments, only when the transaction has not been reported in financial statements that have been issued or made available for issuance.