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ASU 2017-01
Clarifying the Definition of a Business

On January 5, 2017, the FASB issued Accounting Standards Update (ASU) 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business,* which revises the definition in U.S. generally accepted accounting principles (U.S. GAAP) of a "business." This standard includes two related material changes as to how an integrated set of activities and assets should be evaluated to determine if it is a business:

- First, the amendments in ASU 2017-01 introduce a practical screen to be used prior to evaluation of the framework. That screen would exclude certain types of transactions from requiring additional evaluation.
- Second, the amendments change the framework used to consider if the inputs, processes, and outputs in a set are considered a business when the screen is not met.

This report provides a summary of each change, a flowchart which can be used to ensure the proper steps are followed in evaluating a transaction under ASU 2017-01, and illustrative examples of the concepts adopted from the standard.

Definition of a Business

The definition of a business is critical as it impacts many areas of accounting including acquisitions and disposals, goodwill, and consolidation. As the impact of the definition is broad, stakeholders informed the FASB that the existing definition resulted in many transactions qualifying as business acquisitions when in practice they have more in common with an asset acquisition. The broad nature of the existing definition also resulted in additional complicated and costly analysis being required to determine if a transaction was a business.

In addition, the existing definition did not provide room for the use of reasonable judgement in applying the definition. These factors together led to the issuance of ASU 2017-01, which aims to make the definition of a business more usable to stakeholders.

CPEA Observation: This determination (as noted above) is critical because asset acquisitions and business combinations treat a variety of items differently, including:

- Transaction costs, which are expensed in a business combination and capitalized in an asset acquisition; and,
- Contingent consideration which is recognized at the acquisition date fair value in a business combination and generally recognized when resolved in an asset acquisition
- Goodwill is only recognized in business combinations

Further, acquirers in a business combination may obtain information related to the facts and circumstances which existed at the acquisition date during the measurement period, which cannot exceed a year from the acquisition date. In an asset acquisition, there is no measurement period concept.

Introduction of a Screen

The amendments in ASU 2017-01 introduced a screen which is used to determine when a set is not required to be evaluated under the framework discussed above. The screen requires that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not 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.

If the screen is met, the transaction is not a business and should, therefore, not be accounted for as such. If the screen is not met (i.e., passes through the screen), the transaction is evaluated through the modified framework introduced in this standard.

CPEA Observation: The introduction of a screen for assets which can be considered a single identifiable asset, or similar assets, has the potential to reduce the amount of work related to determining if the transaction would need to be evaluated as a business. The introduction of the single identifiable asset concept does not change the existing guidance requiring an entity to allocate the fair value of each asset individually as part of either a business combination or an asset acquisition transaction.

The key determination which must be made in applying the screen is if the assets involved in the transaction meet the single or similar asset threshold. Determining which assets can be combined in order to apply this threshold may require significant judgement, and is conceptually based on how assets would be recognized and measured in a business combination. However, for purposes of this evaluation, the following should be considered a single 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 reduction in utility or fair value to either asset (for example, a building and the land it sits on)
- In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets (for example, a retail store and the favorable lease intangible asset)

Illustration, Adopted from FASB ASC 805-10-55, ¶65-66

Scenario

Pharma Co. purchases from Biotech a legal entity that contains the rights to an in-process research and development project (the "Project"). Included in the Project is the historical know-how, formula protocols, designs, and procedures expected to be needed to complete the related phase of testing. The legal entity also holds an at-market clinical research organization contract and an at-market clinical manufacturing organization contract. No employees, other assets, or other activities are transferred.

Evaluation

Pharma Co. concludes that the Project is an identifiable intangible asset that would be accounted for as a single asset in a business combination. Pharma Co. also qualitatively concludes that there is no fair value associated with the clinical research organization contract and the clinical manufacturing organization contract because the services are being provided at market rates and could be provided by multiple vendors in the marketplace. Therefore, all of the consideration in the transaction will be allocated to the in-process research and development project.

Conclusion

Substantially all of the fair value of the gross assets acquired is concentrated in the single in-process research and development asset. Therefore, the screen is met, and the set is not a business.

In addition to the screen applying to single assets, the screen can also be met for transactions involving similar assets. 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 tangible asset and an intangible asset
- Identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development)
- A financial asset and a nonfinancial asset
- Different major classes of financial assets (for example, accounts receivable and marketable securities)
- Different major classes of tangible assets (for example, inventory, manufacturing equipment, and automobiles)
- Identifiable assets within the same major asset class that have significantly different risk characteristics

Illustration, Adopted from FASB ASC 805-10-55, ¶52-54

Scenario

ABC Property acquires a portfolio of 10 single-family homes that each have in-place leases. The only elements included in the acquired set are the 10 single family homes and the 10 in-place leases. Each single-family home includes the land, building, and property improvements. Each home has a different floor plan, square footage, lot, and interior design. No employees or other assets are acquired. ABC has determined that the building, land and in-place lease at each individual property can be considered a single asset, and is determining if the 10 single assets are similar.

Evaluation

Each home has a different floor plan; however, the nature of the assets (all single-family homes) are similar. ABC also concludes that the risks associated with managing and creating outputs (tenant acquisition, types of customers, tenant management) are not significantly different. Similarly, the risks associated with operating in the real estate market of the homes acquired are not significantly different.

Conclusion

Substantially all of the fair value of the gross assets acquired is concentrated in the group of similar identifiable assets; thus, the screen is met and the set is not a business.

***CPEA Observation**:* The inclusion of the screen will likely result in more real estate only transactions being 'screened out' and, therefore, not required to go through the full framework for evaluating if the set should be considered a business. If there are multiple buildings sold in a portfolio, significant judgement may be required to determine if they would meet the criteria for similar assets.

Changes to the Framework

A business is defined in FASB ASC 805-10-55 as 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.

The clarified definition of a business requires that a set include inputs and a substantive process applied to those inputs that have the ability to contribute to the creation of outputs. Businesses have three elements (defined in FASB ASC 805-10-55-4): input, process, and output. Although businesses usually have outputs, outputs are not required for an integrated set of activities and assets to qualify as a business.

***CPEA Observation**:* An organized workforce can be considered either an input, a process, or both depending on the industry. While the guidance primarily focuses on organized workforce in terms of being integral to executing the processes acquired, for service industries, the workforce would be considered an input. For example, in an accounting firm acquisition, the organized workforce also would be an input and their intellectual capacity would be a process, which together, would be used to generate outputs, audit reports, and tax returns.

Many practitioners have historically started their evaluation of a business based on the outputs. Namely, if revenues were being generated prior to the transaction and subsequent to the transaction, the set was usually considered a business. Under the new framework, the existence of customer contracts (such as supply or lease agreements which would generate revenue) is not part of the analysis of whether a substantive process is included in the acquisition. The framework has different starting points for this evaluation based on when the set includes or does not include an output.

Outputs are Not Present

When there are no outputs included in a set (for example, an early stage company that has not generated revenues), in order to show that the inputs and substantive processes work together to significantly contribute to the ability to create outputs the set would need to include the following items:

- Employees that form an organized workforce that 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 input that the workforce could develop or convert into output

An entity should consider the following in evaluating whether the acquired workforce is performing a substantive process:

- 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
- Inputs that employees who form an organized workforce could develop (or are developing) or convert into outputs could include the following:
    - Intellectual property that could be used to develop a good or service
    - Resources that could be developed to create outputs
    - Access to necessary materials or rights that enable the creation of future outputs

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

Illustration, Adopted from FASB ASC 805-10-55, ¶77-81

Scenario

Widget Co. decided to idle one of their facilities and furlough the assembly line employees. Baily Inc. enters into an agreement to purchase the facility and related equipment from Widget Co. and must legally assume the furloughed employees as well due to local laws. The assets acquired include the equipment and facility (land and building) but no intellectual property, inventory, customer relationships, or any other inputs. Baily has determined that the assets do not meet the screen as the building and equipment are not in the same major class of tangible assets.

Evaluation

The set is not currently producing outputs because there is no continuation of revenue before and after the transaction; therefore, Bailey considers whether the set includes both employees that form an organized workforce and an input that the workforce could develop or convert into output. The set includes employees that have the necessary skills, knowledge, or experience to use the equipment; however, without intellectual property or other inputs that could be converted into outputs using the equipment, the set does not include both an organized workforce and an input that will meet the applicable criteria.

Conclusion

The equipment itself cannot be developed or converted into an output by employees. Therefore, the set does not have an input and is not a business.

In sets that are not producing outputs, an organized workforce that is capable of performing a critical acquired process is required. However, the existence of any employee will not automatically result in the set being considered a business. Significant judgement to determine whether the acquired process performed by the organized workforce is critical in the production of an output is required.

Illustration, Adopted from FASB ASC 805-10-55, ¶73-76

Scenario

Company B owns and operates several television stations in the western United States, and agrees to sell one station (KPOR) to Company A, a television broadcaster which primarily broadcasts their proprietary health-care related programming. Company A plans to change KPOR's format to carry their health-care programming, therefore, Company A will receive only the U.S. Federal Communications Commission license, the broadcasting equipment, and the office building. KPOR will be integrated into Company A's operations, with most of the station processes centralized at Company A's corporate headquarters. Company A will not extend offers of employment to any of KPOR's employees or assume any of KPOR's contractual relationships. Company A has determined that the fair value of the assets acquired is not in a single or similar asset, and therefore does not meet the screen and must be evaluated under the framework.

Evaluation

The set does not have outputs; therefore, Company A considers whether the set includes both an input and a substantive process that together significantly contribute to the ability to create outputs.

Conclusion

The set does not include an organized workforce, therefore, the set does not include both an input and a substantive process and is not considered a business.

Outputs are Present

When the set has outputs (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:

- Employees that form an organized workforce with 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 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).
- 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.
- 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.

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 the preceding paragraph of whether a process has been acquired.

Illustration, Adopted from FASB ASC 805-10-55, ¶82-84

Scenario

Company A, a distributor of food and beverages, enters into an agreement to sublicense the distribution rights of Yogurt Brand X in Latin America to Company B. Company A transfers existing customer contracts to Company B and an at-market supply contract with the producer of Yogurt Brand X. Company A retains all of its employees and distribution capabilities. Company B has determined that the screen is not met, as the license and supply contract are not similar assets, and neither represents a substantially all of the fair value.

Evaluation

The set has outputs through the continuation of revenues with customers in Latin America. As such, Company B must evaluate whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs. Company B considers whether the acquired contracts are providing access to an organized workforce that performs a substantive process. However,

because the contracts are not providing a service that applies a process to another acquired input, Company B concludes that the substance of the contracts are only that of acquiring inputs.

Conclusion
The set is not a business because it does not include an organized workforce or acquired processes that meet the appropriate criteria, and the set does not include both an input and a substantive process.

While this standard removed the requirement to evaluate whether a market participant could replace any missing inputs or processes in determining if a set qualifies as a business, the requirement to determine whether a particular set of assets and activities is capable of being conducted and managed as a business by a market participant was retained. 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.

Adoption Dates & Implementation

Public business entities should apply the amendments in ASU 2017-01 to annual periods beginning after December 15, 2017, including interim periods within those periods. All other entities should apply the amendments to annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. The amendments in ASU 2017-01 should be applied prospectively on or after the effective date. No disclosures are required at transition.

Early application of the amendments in ASU 2017-01 is allowed for transactions for which the acquisition date occurs in a period for which financial statements have not been issued or made available for issuance. Early application of the amendments in ASU 2017-01 also is allowed for transactions in which a subsidiary is deconsolidated or a group of assets is derecognized that occur in a period for which financial statements have not been issued or made available for issuance.

Practice Note: As indicated above, the amendments in ASU 2017-01 can be early adopted. Some entities may find early adoption preferable insofar as the amendments in ASU 2017-01 narrow the definition of a business. The accounting requirements related to purchasing and selling a “business” are more complicated compared to the accounting requirements related to purchasing or selling an asset or group of assets. There also are accounting differences when acquiring a business as compared to a group of assets, such as the recognition of goodwill and the treatment of acquisition related costs.

Flowchart to Help Determine Whether a Set is a Business