Clarifying the Definition of a Business

PCC Outreach

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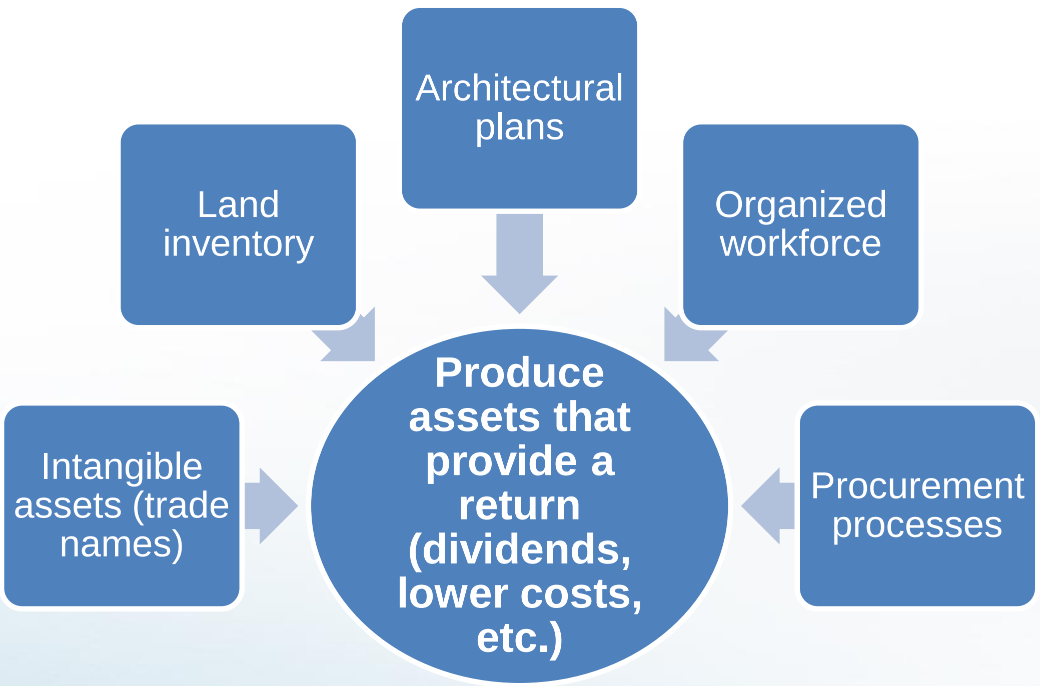
December 2014

FINANCIAL ACCOUNTING STANDARDS BOARD

Current Definition

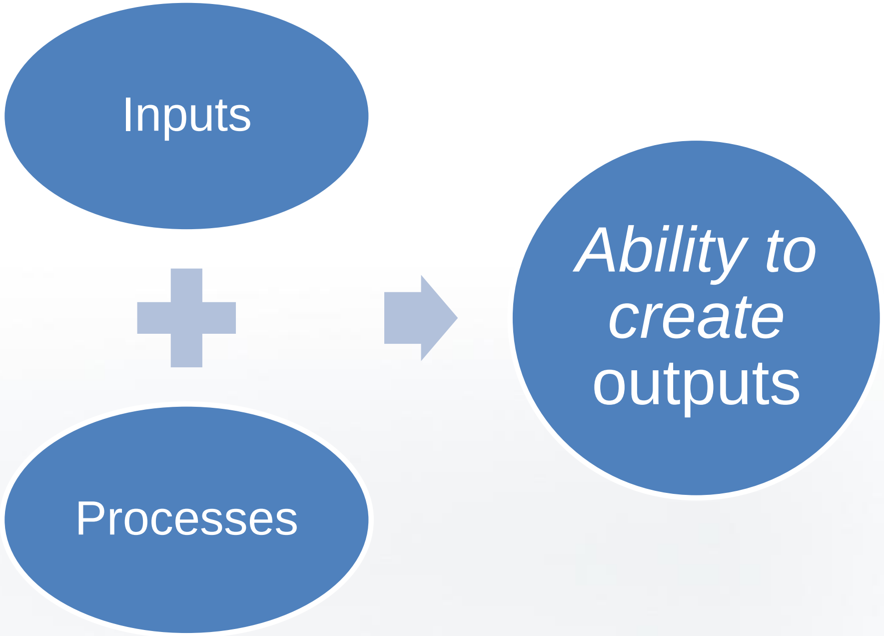
Master Glossary



- 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. Additional guidance on what a business consists of is presented in paragraphs 805-10-55-4 through 55-9.

Current Definition

- Excerpts from ASC 805-10-55-4 through 55-9
  - A business consists of inputs and processes applied to those inputs that have the ability to create outputs. Although a business usually has outputs, outputs are not required to qualify as a business.
  - A business need not include all of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs.
  - In the absence of evidence to the contrary, a particular set of assets and activities in which goodwill is present shall be presumed to be a business. However, a business need not have goodwill.



Where the Current Definition is Primarily Used:

- Topic 805, Business Combinations
- Topic 810, Consolidations (including VIE scope exception)
- Topic 505, Equity – Spinoffs and Reversals
- Topic 205, Presentation – Discontinued Operations
- Topic 350, Goodwill and Intangibles
- Topic 360, Property, Plant and Equipment (pending)
- Topic 610, Revenue (pending)

Reasons for Adding the Project

- Issues raised within the new revenue standard
  - In substance nonfinancial assets are in scope but undefined
  - The standard supersedes the partial sales guidance in FAS 66, leaving no guidance on partial sales of real estate

- Post-implementation review (PIR) of Statement 141(R), *Business Combinations*
  - Stakeholder feedback indicated that the definition is too broad
    - While the definition is converged under U.S. GAAP and IFRS, it generally is applied more broadly under U.S. GAAP, which leads to more acquisitions qualifying as businesses
      - IASB currently is conducting a PIR of IFRS 3, *Business Combinations*

Reasons for Broad Interpretations

SEC interpretations

No requirement for outputs

No requirement for all processes to be in place (if processes can be easily replaced by a market participant)

Can result in a business consisting primarily of inputs and little, if anything, else

Examples – Broad Interpretations

- Acquisition of a five-story office building; four stories will be used as a corporate headquarters by the acquirer, and one story will continue to be leased to existing tenants
  - If the leasing processes can be replaced by a market participant and the revenue-generating activity is the same before and after, the acquired set would be a business
- Acquisition of a license to a product candidate in the biotech industry
  - If a market participant is capable of applying its own processes to continue development of the product candidate, the acquired set would be a business
- Acquisition of a mineral interest (with exploration in process that has indicated that mineral reserves exist)
  - If a market participant is capable of applying its own processes to continue the exploration (geological studies and surveys and drilling of exploratory wells), the acquired set would be a business

Why Does It Matter?

	Asset	Business
Partial Sales	Oil and gas: gain or loss can be recognized on the sale of part of a proved property or an interest constituting part of an amortization base Nonmonetary exchanges: partial gain recognized if ownership interest received is accounted for under the equity method Real estate: example retained in Topic 970 in which formation of a joint venture is treated as sale of half of the interest in the real estate Other nonfinancial assets: no guidance	Controlling interest sold: gain recognized Less than a controlling interest sold: no gain recognized (treated as capital contribution)
Retained Interests	Oil and gas: unamortized cost of the property sold is allocated to the interest transferred and interest retained on a relevant fair value basis Other nonfinancial assets: no guidance	Noncontrolling interest retained: remeasured at fair value
Partial Acquisitions	No guidance	Controlling interest obtained: measured at fair value for 100% of acquired net assets Noncontrolling interest obtained: accounted for under cost method or equity method

Why Does It Matter?

	Asset	Business
Contingent Consideration	Not recognized until the contingency is resolved	Recognized at the acquisition date fair value while changes in estimate are trued-up through earnings after the acquisition date
In-Process Research and Development	Expensed as incurred unless it has an alternative future use	Capitalized at fair value and accounted for as an indefinite-lived intangible asset until completion or abandonment of the project (expensed as incurred after the acquisition date)
Acquisition-Related Costs	Capitalized	Expensed
Initial Measurement	Allocated cost on a relative fair value basis	Measured at fair value
Bargain Purchase Amount	Allocated to identifiable assets and liabilities on a relative fair value basis	Recognized immediately in earnings as a gain

Moving Forward With Asset Versus Entity Differences

- Project to incorporate:
  - Clarifying the definition of a business
  - Clarifying accounting for partial sales and retained interests
  - Considering whether other asset versus entity differences can be eliminated

Questions?