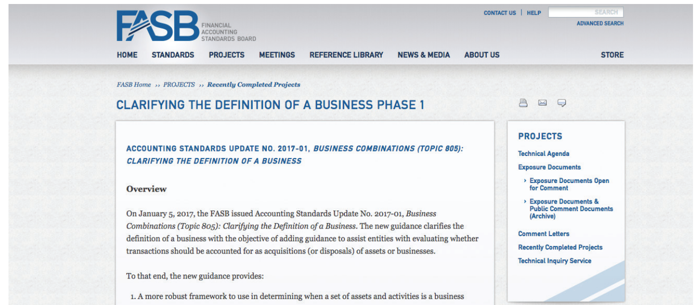
FASB Clarifies Definition of a Business

By C. William (Bill) Thomas, CPA, Ph.D.

On Jan. 5, 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2017-1, *Business Combinations (Topic 805): Clarifying the Definition of a Business*. The objective of the new ASU is to assist companies and other reporting organizations with evaluating whether sales transactions of productive assets should be accounted for as acquisitions (or disposals) of businesses or merely assets.



What's the Issue?

What difference does it make in a sale (or purchase) transaction whether the object of the transaction is an asset or a business? The answer is that it can make quite a difference on the seller's financial statements in reporting gains or losses on such transactions, and on the purchaser's financial statements as to whether goodwill (and thereafter, subsequent impairment) is recorded, as well as whether the rules for consolidations might apply while the set of assets is held.

For example, on the sell side, if the transaction is accounted for as an asset sale, gains and losses on such sales are combined for reporting purposes with other gains and losses in income from operations. If the transaction is accounted for as a sale of a business, it is often presented as a separate line item on the income statement, net of tax effects, and may later be excluded on a pro-forma basis in reporting earnings from ongoing operations (non-GAAP measures).

Accounting for Business Combinations is covered in Topic 805 of the Accounting Standards Codification (ASC). Under this topic, there are three elements of a business – inputs, processes and outputs. While an integrated set of assets and activities, a "set," that is a business usually has outputs, outputs are not required to be present. In addition, 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.

A post-implementation review of this topic by FASB revealed that many stakeholders believed Topic 805's definition of a business was applied too broadly, resulting in many transactions being reported as business acquisitions when, in fact, they were more akin to asset acquisitions. Many stakeholders stated that analyzing transactions under the existing definition is difficult and costly. In addition, the scope of Subtopic 610-20, *Other Income – Gains and Losses from the De-recognition of Nonfinancial Assets*, raised questions about the interaction of the definition of a business and the term "in-substance non-financial asset" as used in that subtopic.

What's the Effect of the New ASU?

ASU 2017-1 provides a more robust framework to use in determining when a set of assets and activities constitutes a business. Thus, the new framework should provide more consistency in applying the definition and reduce the cost of implementation. The new framework sets up a screen to determine when a set is not a business. The screen requires that when substantially all 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. If a transaction is caught by the screen, then 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.

The new standard removes the evaluation of whether a market participant could replace the missing elements of the set. The new standard provides a framework to assist entities in evaluating whether both an input and a substantive process are present. This framework includes two sets of criteria to consider that depend on whether a set has outputs. Although outputs are not required for a set to be a business, they are generally a key element of whether a business exists. The new ASU includes more stringent criteria for a set without outputs to be classified as a business. In addition, the ASU narrows the definition of the term output to be consistent with the definition of the term used in updated ASU section 606 on revenue recognition.

When is the New Standard Effective?

For public companies, ASU 2017-1 is effective for annual periods beginning after Dec. 15, 2017, including interim periods within those periods. For all other companies and organizations, the effective date is annual periods beginning after Dec. 15, 2018, and interim periods within annual periods beginning after Dec. 15, 2019.

For a full reading of ASU 2017-1, see www.fasb.org.

C. William Thomas, CPA, Ph.D. is the J.E. Bush professor of accounting in the Hankamer School of Business at Baylor University in Waco. Thomas can be reached at Bill_Thomas@baylor.edu.