

# FASB In Focus

## Proposed Accounting Standards Update

### Business Combinations (Topic 805): Clarifying the Definition of a Business

On November 23, 2015, the Financial Accounting Standards Board (FASB) issued a proposed Accounting Standards Update (ASU) intended to clarify the definition of a business, with the objective of adding guidance that would assist reporting organizations with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses.

Stakeholders are encouraged to review and provide comment on the proposal by January 22, 2016

#### Why Is the FASB Issuing This Proposed ASU?

The definition of a business in Generally Accepted Accounting Principles (GAAP) is important because it affects many areas of accounting, including acquisitions, disposals, goodwill, and consolidation.

Many stakeholders have told the FASB that the definition of a business in Topic 805, Business Combinations, is applied too broadly. Consequently, many transactions qualify as business combinations when in fact, these stakeholders believe, they are more akin to asset acquisitions. Additionally, stakeholders have said that analyzing transactions

under the current definition can be difficult and costly. These concerns about the definition of a business were among the primary issues raised in connection with the Post-Implementation Review (PIR) Report on FASB Statement No. 141 (revised 2007), *Business Combinations* (Statement 141), now codified in Topic 805.

The proposed ASU seeks to address these concerns by providing a more robust framework to determine when a set of assets and activities is a business. The new amendments are intended to provide more consistency in the application of the guidance, reduce the costs of its application, and make the definition of a business more operable.

#### How Is a Business Defined in Current GAAP?

Current GAAP contains implementation guidance on how to evaluate whether an acquired set of activities and assets (collectively referred to as a “set”) is a business. Under that implementation guidance, there are three elements of a business: inputs, processes, and outputs.

While a set that is a business usually will have outputs, outputs are not required to be present.

In addition, all of the inputs and processes that the seller uses in operating a set are not required if market participants are capable of acquiring the set and continuing to produce outputs, for example, by integrating the set with its own inputs and processes. Current GAAP does not specify the minimum inputs and processes required for a set to meet the definition of a business. That lack of clarity has led to broad interpretations in practice of what a business is.

Some stakeholders have said that a set may qualify as a business even if no processes are included in the transaction when revenue-generating activities continue after an acquisition. For example, in the real estate industry, a market participant often is capable of acquiring inputs (a building with leases) and combining them with its own processes to continue generating outputs (lease income). Other stakeholders have said that the presence of any processes can give rise to a business, regardless of significance.

The definition of outputs in current GAAP refers to the ability to provide a return in the form of dividends, lower costs, or

other economic benefits directly to investors or other owners, members, or participants. Many transactions can provide a return in some form (for example, the acquisition of a new machine could be expected to lower costs). Thus, the definition of outputs contributes to broad interpretations of what meets the definition of a business.

### **How Would the Proposed Guidance Clarify the Definition of a Business?**

The proposed amendments would require that to be considered a business, a set must include—at a minimum—an input and a substantive process that together contribute to the ability to create outputs, and would remove the evaluation of whether a market participant could replace any missing elements. The proposed guidance also would provide a framework to assist organizations in evaluating whether both an input and a substantive process are present.

In addition, the proposed guidance would include a screen

that would reduce the number of transactions that need to be evaluated under that framework. When applying that screen, a set would not be a business when substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets.

Finally, the proposed guidance would narrow the definition of “outputs” so that the term is consistent with how outputs are described in the new revenue recognition standard.

### **How Does the Proposed Amendments Compare with International Financial Reporting Standards (IFRS)?**

The definition of a business in GAAP currently is identical to the definition in IFRS. However, the Board observed that it does not appear to be interpreted or applied consistently in practice between jurisdictions that apply GAAP and those that apply IFRS. Stakeholders have said that in jurisdictions that apply IFRS, the definition of a business generally

is not applied as broadly as it is in jurisdictions that apply GAAP.

The Board’s intent is to narrow the application of the definition in GAAP so that practice under GAAP and IFRS may be more closely aligned. The IASB has added a project on the definition of a business to its agenda and is considering similar amendments to those in this proposed ASU.

### **When Would the Proposed Guidance Be Effective?**

The changes set forth in the proposed ASU would be applied prospectively to any transaction that occurs on or after the effective date. No disclosures would be required at transition. The FASB will determine the effective date and whether the proposed changes may be applied before the effective date after it considers stakeholder feedback.

**For more information about the project, please visit the FASB’s website at [www.fasb.org](http://www.fasb.org).**