Accounting & Auditing Update

FASB Narrows the Definition of a Business

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The Financial Accounting Standards Board (FASB or the Board) recently issued Business Combinations (Topic 805), Accounting Standards Update (ASU) 2017-01, ***Clarifying the Definition of a Business***. The guidance is intended to assist an entity with evaluating whether a transaction should be accounted for as an acquisition of an asset or that of a business. The definition of a business affects many areas: acquisitions, disposals, goodwill, and consolidations.

Because the existing guidance was considered to be applied too broadly — resulting in many transactions being recorded as business acquisitions — the new ASU provides clarifying parameters. The new ASU is expected to result in more transactions being accounted for as asset acquisitions rather than business combinations. Determining whether to classify a transaction as an asset acquisition or a business acquisition is critical given that the accounting for each is significantly different.

In particular, transaction costs are capitalized in an asset acquisition, rather than expensed as required in a business combination. In addition, contingent consideration is recognized only when the contingency is resolved in an asset acquisition, rather than recognized at its fair value on the acquisition date in a business combination.

Introduction of the "Screen"

The new ASU introduces a "screen" to assist management in determining if an integrated set of activities and assets should not be considered a "business."

Under the new guidance, an entity first determines whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. 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 of transferred assets and activities (the set) is not a business.

There is practical guidance in the ASU as to what to include in gross assets and what constitutes a single identifiable asset or group of similar identifiable assets in the context of applying the screen.

Definition of a Business

If the transaction does not meet the screening test described above, then the ASU requires that the entity evaluate whether the set meets the requirement that the business include, at a minimum, an input and substantive process that together significantly contribute to the ability to create outputs.

A business is an integrated set of activities and assets capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits to its owners, members or participants.

Other Accounting Treatment Consequences

The definition of a business also affects the accounting for dispositions and the identification of reporting units. It also may affect how a reporting entity applies the consolidation guidance.

Effective Date

For public business entities with a calendar year-end, the ASU is effective in 2018. All other entities have an additional year. Early adoption is permitted.

The ASU can be applied to transactions occurring before the guidance was issued (January 5, 2017) as long as the applicable financial statements have not been issued. The changes in the definition of a business may result in more acquisitions being accounted for as asset acquisitions across all industries, particularly real estate, pharmaceutical, and oil or gas. Also, it will likely affect the accounting for disposal transactions.

Full Text

This ASU may be accessed on the FASB website.

Contact Us

For more information about this new ASU, please contact John Haslbauer, CPA, Partner at jhaslbauer@pkfod.com or your PKF O'Connor Davies' advisor.

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