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Viewpoint

Identifying business combinations

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Contents

Introduction....4
1. Business combinations defined....5
2. Obtaining control over an acquiree....7
3. Definition of a business....10
 3.1 Screen test....12
  3.1.1 Screen test: Single or similar identifiable asset....15
  3.1.2 Screen test: Identifying a group of similar assets....15
  3.1.3 Screen test: Gross assets acquired....16
 3.2 The framework: If the screen is not met....17
  3.2.1 The framework: Elements of a business....17
  3.2.2 The framework: Set without output....20
  3.2.3 The framework: Set with output....21
  3.2.4 The framework: Presence of more than insignificant goodwill....23
 3.3 Illustrative examples: Identifying a business....23
4. Transactions not considered business combinations....36
 4.1 Formation of a joint venture....36
 4.2 Acquisitions not meeting definition of business or not-for-profit activity....37
 4.3 Transactions between entities under common control....37
 4.4 Not-for-profit entities....38
 4.5 Collateralized financing entities....38
Appendix....40

Introduction

The guidance in ASC 805 requires an acquiring entity to apply the acquisition method of accounting when it acquires a business or a not-for-profit activity. The acquisition method of accounting requires an entity to (a) identify the acquirer; (b) determine the acquisition date; (c) recognize and measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; and (d) recognize and measure goodwill or gains from a bargain purchase.

This Viewpoint discusses how to identify whether a transaction or event that results in an entity obtaining control of a set of net assets should be accounted for as a business combination.

This publication discusses only transactions within the scope of ASC 805-10, ASC 805-20, ASC 805-30, and ASC 805-40. It does not apply, however, to transactions or events within the scope of ASC 805-50, which has its own discrete scope covering asset acquisitions, transactions between entities under common control, the formation of master limited partnerships, and pushdown accounting.

1. Business combinations defined

In a business combination, the acquiring entity obtains control of one or more businesses. Business combinations also include transactions or events in which a not-for-profit entity obtains control of one or more nonprofit activities or businesses and initially recognizes the acquired assets and liabilities in its financial statements.

The guidance in ASC 805 requires an acquiring entity to apply the acquisition method of accounting to all business combinations, which occur when the entity obtains control over the assets acquired and liabilities assumed, often referred to as the acquired set of net assets, or the acquiree, that constitute a business. (See Section 3 for a discussion of the definition of a "business.")

Under the guidance in ASC 805, acquiring entities may obtain control of an acquiree from the seller by transferring to the seller various forms of consideration, such as cash or equity interests, or by incurring liabilities. The guidance also explains that a business combination can occur without the acquiring entity transferring any consideration, as illustrated in the following examples:

- The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control of the acquiree.
- A noncontrolling interest holder's veto rights in an acquiree lapse in which the acquiring entity owns majority voting interest.
- The acquiring entity obtains control by entering into a contractual arrangement with the acquiree, such as a "stapling arrangement," or by forming a dual-listed corporation.

In a "stapling arrangement," the equity securities of one entity are combined with the equity securities of another legal entity and, once combined, can only be traded or transferred together. In a dual-listed corporation structure, two listed companies enter into an agreement to be managed as a single entity, but their securities remain separately listed in the respective capital markets. These transactions are still considered business combinations, even though one entity does not acquire an ownership interest in another entity and the two entities are not combined together to form a single legal entity.

A transaction in which the acquired set of net assets does not constitute a business is accounted for as an asset acquisition under ASC 805-50.

Business Combination: A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations.

Acquisition by a Not-for-Profit Entity: A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements. When applicable guidance in Topic 805 is applied by a not-for-profit entity, the term business combination has the same meaning as this term has for a for-

profit entity. Likewise, a reference to business combinations in guidance that links to Topic 805 has the same meaning as a reference to acquisitions by not-for-profit entities.

ASC 805-10-25-1

An entity shall determine whether a transaction or other event is a business combination by applying the definition in this Subtopic, which requires that the assets acquired and liabilities assumed constitute a business. If the assets acquired are not a business, the reporting entity shall account for the transaction or other event as an asset acquisition. An entity shall account for each business combination by applying the acquisition method.

Identifying a Business Combination

ASC 805-10-55-2

Paragraph 805-10-25-1 requires an entity to determine whether a transaction or event is a business combination. In a business combination, an acquirer might obtain control of an acquiree in a variety of ways, including any of the following:

a. By transferring cash, cash equivalents, or other assets (including net assets that constitute a business)

b. By incurring liabilities

c. By issuing equity interests

d. By providing more than one type of consideration

e. Without transferring consideration, including by contract alone (see paragraph 805-10-25-11).

ASC 805-10-55-3

A business combination may be structured in a variety of ways for legal, taxation, or other reasons, which include but are not limited to, the following:

a. One or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer.

b. One combining entity transfers its net assets or its owners transfer their equity interests to another combining entity or its owners.

c. All of the combining entities transfer their net assets or the owners of those entities transfer their equity interests to a newly formed entity (sometimes referred to as a roll-up or put-together transaction).

d. A group of former owners of one of the combining entities obtains control of the combined entity.

2. Obtaining control over an acquiree

A business combination occurs when the acquirer obtains control of the acquired business. The term "control," as defined in ASC 805, has the same meaning as the phrase "controlling financial interest" used in ASC 810-10-15-8. Therefore, the acquiring entity should assess whether it has obtained control of the acquiree by applying the guidance on consolidations in ASC 810.

ASC 810-10-15-8

For legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

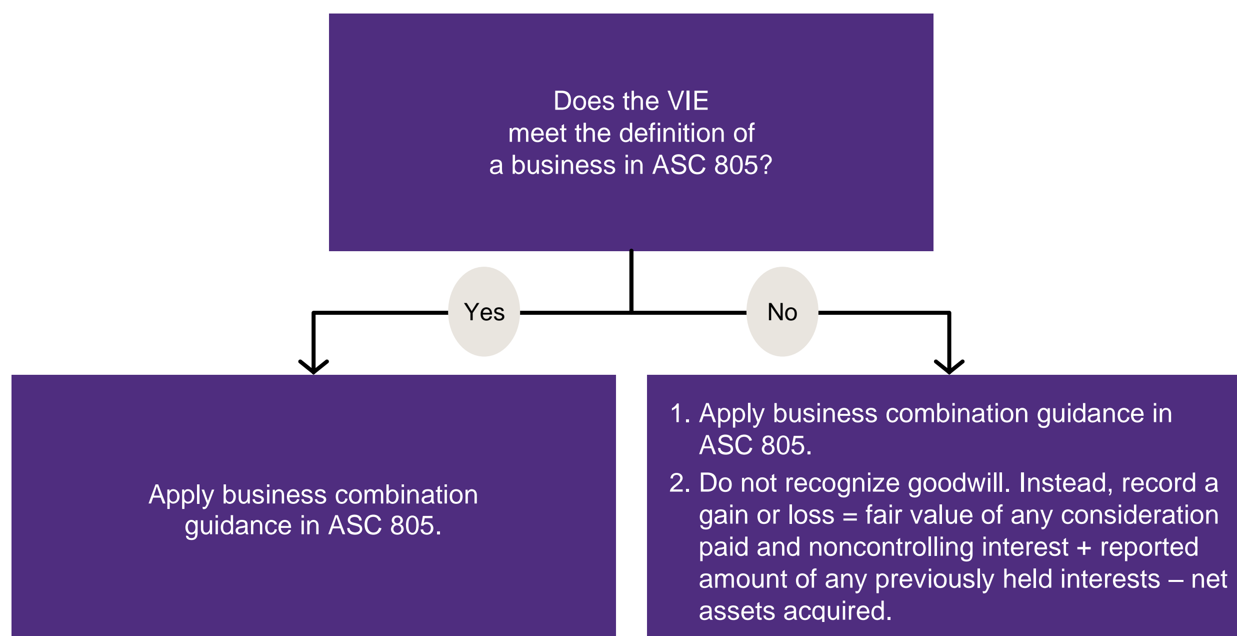
The guidance in ASC 810 contains two consolidation models to evaluate whether an entity has obtained a controlling financial interest in an acquiree: the *variable interest entity (VIE) model* and the *voting interest entity model*.

To determine whether an acquirer has gained control, the acquirer should first apply the VIE model and determine whether the acquiree is a VIE. If the acquiree qualifies as a VIE, the acquiring entity should then evaluate whether it has obtained a controlling financial interest in the VIE. Under ASC 810, an acquirer obtains control of a VIE if it (1) has the power to direct the activities of the VIE that most significantly impact the VIE's economic performance, and (2) is obligated to absorb the losses of the VIE that could potentially be significant to the VIE, or has the right to receive benefits from the VIE that could potentially be significant to the VIE.

If the acquirer concludes that it has obtained a controlling financial interest in the VIE and the VIE meets the definition of a business, the acquirer would initially measure the acquired business in accordance with the business combination guidance in ASC 805. If the VIE does not meet the definition of a business, however, the acquirer would apply the guidance on business combinations in ASC 805 to recognize the acquired assets and liabilities, but it would not recognize goodwill and would instead record a loss.

If the acquiree does not qualify as a VIE, then the acquirer would next apply the voting interest model to determine whether it has obtained a controlling financial interest in the acquiree. In general, an entity gains a controlling financial interest in a voting interest entity if it owns a majority voting interest, according to the guidance in ASC 810.

Figure 2.1: Application of ASC 805 when acquiree is a VIE



Valuation of Assets, Liabilities, and Noncontrolling Interests in a Newly Consolidated VIE

Entities Not under Common Control

ASC 810-10-30-2

The initial consolidation of a VIE that is a business is a business combination and shall be accounted for in accordance with the provisions in Topic 805.

All Primary Beneficiaries

ASC 810-10-30-3

When a reporting entity becomes the primary beneficiary of a VIE that is not a business, no goodwill shall be recognized. The primary beneficiary initially shall measure and recognize the assets (except for goodwill) and liabilities of the VIE in accordance with Sections 805-20-25 and 805-20-30. However, the primary beneficiary initially shall measure assets and liabilities that it has transferred to that VIE at, after, or shortly before the date that the reporting entity became the primary beneficiary at the same amounts at which the assets and liabilities would have been measured if they had not been transferred. No gain or loss shall be recognized because of such transfers.

ASC 810-10-30-4

The primary beneficiary of a VIE that is not a business shall recognize a gain or loss for the difference between (a) and (b):

a. The sum of:
    1. The fair value of any consideration paid
    2. The fair value of any noncontrolling interests
    3. The reported amount of any previously held interests
b. The net amount of the VIE's identifiable assets and liabilities recognized and measured in accordance with Topic 805.

3. Definition of a business

Under ASC 805, an acquired set of activities and net assets must meet the definition of a “business” in order for the acquiring entity to apply the acquisition method of accounting to the acquired set.

As an initial step in determining whether an acquired set comprises a business, the guidance in ASC 805 provides a “screen” to determine when a set does not qualify as a business and, therefore, should instead be accounted for as an asset acquisition.

Under the screen, if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or in a group of similar identifiable assets, the acquired set is not a business and no further assessment is required.

If the screen is not met, however, an entity should then determine whether the acquired set is a business by using a framework described in ASC 805, based on whether or not the acquired set generates outputs (see Section 3.1 for more information about the screen).

Business: Paragraphs 805-10-55-3A through 55-6 and 805-10-55-8 through 55-9 define what is considered a business.

The guidance in the FASB Codification referenced in this definition of a “business” is included in Section 3.2.

Figure 3.1 provides an overview of the guidance in ASC 805 for determining whether an acquired set of net assets meets the definition of a business.

Figure 3.1: Identifying a business

Is substantially all fair value of acquired set concentrated in a single identifiable asset or group of similar identifiable assets (screen test)?

- Yes → Asset acquisition
- No → Does the acquired set generate outputs?
  - No → Does the acquired set include an organized workforce and an input that the workforce could develop or convert into output?
    - Yes → Business combination
    - No → Asset acquisition
  - Yes → Does the acquired set include both an input and a substantive process?
    - Yes → Business combination
    - No → Asset acquisition

Definition of 'business' for SEC reporting

The definition of a "business" in ASC 805 is different than the SEC's definition of a business under Rule 11-01(d) of Regulation S-X. As a result, a transaction that is not accounted for as an acquisition of a business in the registrant's U.S. GAAP financial statements may still be an acquisition of a business for SEC reporting purposes for which pre-acquisition financial statements and related pro forma financial information may be required.

For SEC reporting purposes, the objective is to determine whether additional financial statements are necessary for making investment decisions, which may not always align with the financial reporting objectives under U.S. GAAP. The determination of a business for SEC reporting purposes is a legal matter that focuses on the continuity of the acquiree's operations before and after the acquisition. While revenue is one of the factors indicating whether there is continuity of operations, it is not the only

factor. Accordingly, an acquiree that does not have any revenue might still meet the definition of a business under S-X Rule 11-01(d).

For SEC reporting purposes, a separate entity, subsidiary, or division is presumed to be a business. Further, a lesser component of an entity may also constitute a business. In evaluating whether an acquisition of a lesser component is a business, the registrant will consider the continuity of operations as well as other factors outlined in S-X Article 11, such as whether the acquiree's physical facilities, employees, or customer base will remain unchanged.

Definition of 'business' for SEC filings

An entity acquires 100 percent of the equity interest of Entity A, which owns an office park with 10 office buildings, all leased to maximum occupancy. The only elements that are included in the acquired set are the office buildings and in-place leases. The acquirer concludes that the land, office buildings, and in-place leases, as well as property improvements, should be considered a single asset in accordance with ASC 805-10-55-5B, because the building and property improvements are attached to the land and cannot be removed without incurring significant cost (see Section 3.1). Additionally, the in-place leases are an intangible asset that should be combined with the related real estate and considered a single asset.

Consequently, the acquirer concludes that substantially all of the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets and that the acquisition is not, therefore, a business combination under ASC 805 but is instead an asset acquisition. However, since the revenue-producing activity of the acquired set would remain the same before and after the acquisition, the acquirer also concludes that the acquisition qualifies as a business for SEC reporting purposes

3.1 Screen test

As an initial step in determining whether an acquired set of net assets is a business, the guidance in ASC 805 provides a screen test to determine when a set is not a business. The screen test states that if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or in a group of similar identifiable assets, the acquired set of net assets is not a business, and the acquiring entity should instead account for the acquired set as an asset acquisition.

ASC 805-10-55-5A

If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar assets, the set is not considered 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.

ASC 805-10-55-5B

A single identifiable asset includes any asset or group of assets that could be recognized and measured as a single identifiable asset in a business combination. However, for purposes of this evaluation, the following should be considered a single asset:

a. 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 diminution in utility or fair value to either asset (for example, land and building)

b. In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets.

ASC 805-10-55-5C

A group of similar assets includes multiple assets identified in accordance with paragraph 805-10-55-5B. 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. A tangible asset and an intangible asset

b. Identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development)

c. A financial asset and a nonfinancial asset

d. Different major classes of financial assets (for example, accounts receivable and marketable securities)

e. Different major classes of tangible assets (for example, inventory, manufacturing equipment, and automobiles)

f. Identifiable assets within the same major asset class that have significantly different risk characteristics.

Grant Thornton insights: Determining 'substantially all'

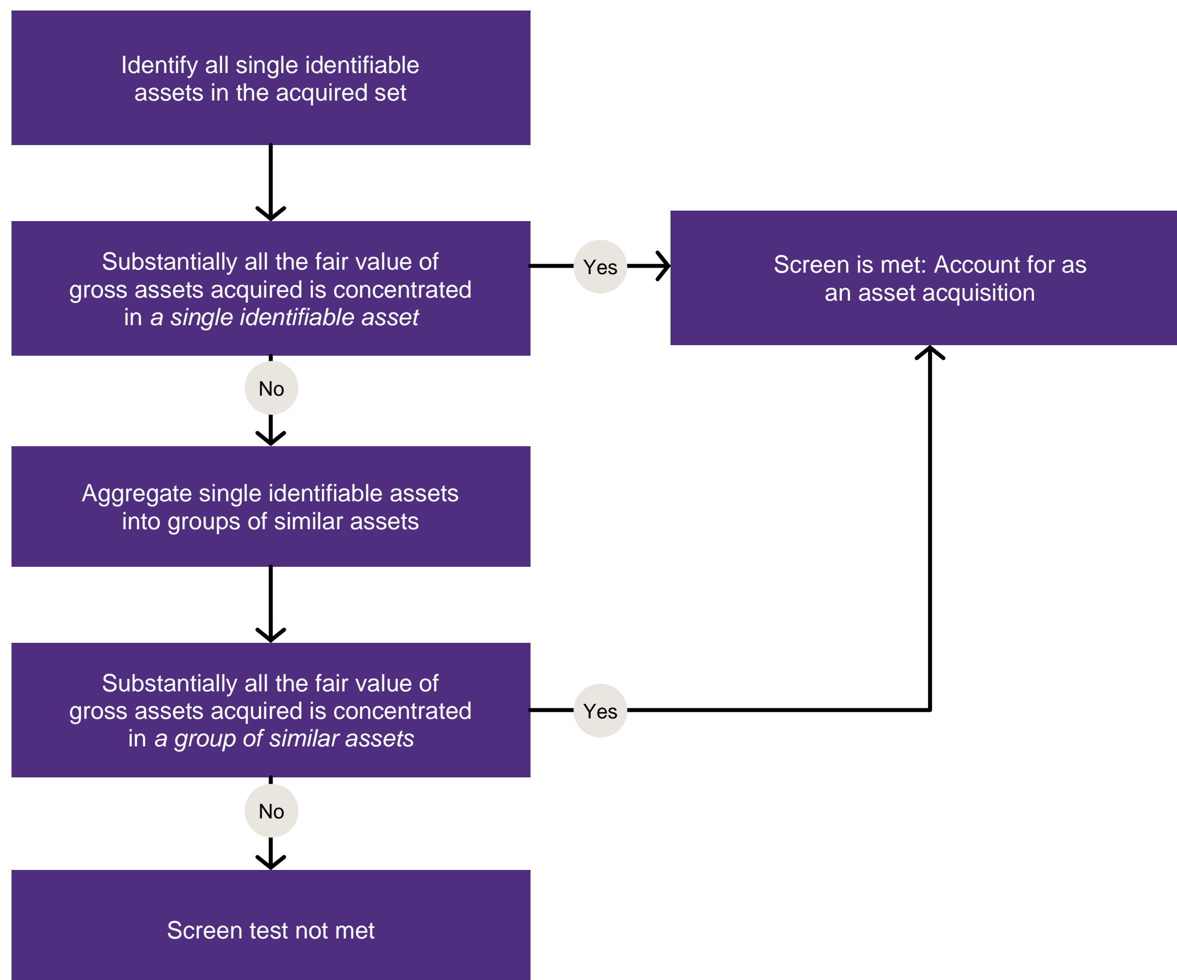
Although the guidance in U.S. GAAP does not define "substantially all" as used in the screen test in ASC 805, the guidance in several other Codification Topics uses this same threshold, including the revenue guidance in ASC 606, the leasing guidance in ASC 842, and the consolidation guidance in ASC 810. We believe that it would be reasonable for an entity to use a 90 percent threshold to evaluate in the screen test whether "substantially all" of the fair value of gross assets acquired in a transaction comprises a single identifiable asset or group of similar assets, resulting in an asset acquisition rather than a business combination. However, an entity's use of the "substantially all" threshold should be consistent with how the entity uses this threshold when applying other ASC Topics.

The determination of substantially all of the fair value of gross assets acquired implies using a quantitative approach, but U.S. GAAP does not require entities to apply such approach. An entity could use qualitative considerations in certain circumstances, for example, when facts and circumstances indicate that either

substantially all of the fair value lies in one asset or a group of similar identifiable assets, and it is apparent that the screen will be met (or, on the other hand, the fair value is in assets that are not similar, and the screen will not be met). Entities should evaluate the facts and circumstances of each situation and not view a qualitative assessment either as an option available in all situations or as evidence typically compelling enough to override a conclusion based on appropriate quantitative evidence. Despite some qualitative aspects involved in assessing whether a transaction involves a business, an entity nonetheless is required to determine the fair values of each asset when recording a business combination or an asset acquisition. Therefore, any qualitative considerations are not expected to reduce either the cost or complexity of the ultimate accounting.

Figure 3.2 summarizes the guidance for applying the screen.

Figure 3.2: Applying the screen



3.1.1 Screen test: Single or similar identifiable asset

When applying the screen test, an entity should first identify any single identifiable assets in the acquired set. The guidance in ASC 805 requires that a group of assets that can be recognized and measured as a single identifiable asset in a business combination should be considered a single identifiable asset for the purposes of applying the screen test. For example, a group of complementary intangible assets commonly referred to as an entity's brand may be recognized as a single asset in a business combination if those assets have similar useful lives.

The guidance in ASC 805-10-55-5B requires that entities always consider the following assets as a single identifiable asset for the purpose of applying the screen test. However, such grouping only applies to performing the screen test; these assets should be recognized and measured as separate assets regardless of whether the acquisition is accounted for as a business combination or an asset acquisition:

- Tangible assets attached to each other that cannot be physically removed and used separately without either incurring significant cost or significantly reducing either asset's utility or fair value. For example, a building and the land where the building is constructed are together considered a single identifiable asset. Another example of a single identifiable asset is a pipeline together with the associated ground lease.
- Intangible assets representing the right to use a tangible asset, such as in-place lease intangibles (including favorable and unfavorable lease intangibles) and the related leased tangible asset.

Once all single identifiable assets in the acquired set are identified, the acquirer should assess whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset. If so, the screen test is met, and the acquired set is accounted for as an asset acquisition.

Grant Thornton insights: Assembled workforce as single identifiable asset

Under the screen test guidance, a single identifiable asset is one that can be recognized and measured as an identifiable asset in a business combination. Since ASC 805-20-55-6 states that an assembled workforce is not an identifiable asset that can be recognized separately from goodwill, the workforce is not considered a single identifiable asset for the purpose of applying the screen test, even though it would be recognized as a separate intangible asset if the acquired set of net assets is recognized as an asset acquisition.

3.1.2 Screen test: Identifying a group of similar assets

If the acquired set of net assets includes multiple single identifiable assets, and if the fair value of the gross assets acquired is not concentrated in any one of the single identifiable assets, an entity must then determine whether any of these single identifiable assets should be aggregated into a group (or groups) of similar identifiable assets for the purpose of applying the screen test.

An entity should evaluate whether the assets are similar, and should therefore be aggregated for the purposes of applying the screen test, by considering the nature of the assets and the risks associated with managing and creating outputs from the assets.

The guidance states that the following assets should not be considered similar assets for the purposes of applying the screen test:

- A tangible asset and an intangible asset that, together, are not considered a single identifiable asset
- Identifiable intangible assets in different major identifiable asset classes, such as customer-related intangibles and in-process research and development
- A financial asset and a nonfinancial asset
- Financial assets in different major classes, such as accounts receivable and marketable securities
- Tangible assets in different major classes, such as inventory, manufacturing equipment, and vehicles
- Identifiable assets within the same major asset class that have significantly different risk characteristics, such as proved oil and gas properties and unproved oil and gas properties, or commercial and residential real estate

3.1.3 Screen test: Gross assets acquired

The amount of gross assets acquired consists of the consideration transferred (including the fair value of any noncontrolling interests and previously held interests) that exceeds the fair value of the net identifiable assets acquired (that is, goodwill in a business combination). In calculating the consideration transferred in a business combination, an entity should include all forms of consideration, for example, cash, contingent consideration, and noncash amounts. Cash and cash equivalents, deferred tax assets, and any goodwill resulting from the effects of deferred tax liabilities should be excluded from gross assets acquired.

Further, for purposes of the screen test, gross assets are not reduced by debt, such as assumed mortgage debt related to an acquired building. Paragraph 20 in the Basis for Conclusions (BC20) in ASU 2017-01 explains that the FASB intended to avoid debt or other liabilities impacting gross assets when applying the screen. That is, subtracting liabilities from the gross assets acquired could potentially exempt from further assessment a group of assets that would otherwise not meet the screen solely because the transaction includes liabilities in addition to assets.

Consideration of liabilities in determining gross assets acquired

Assume that the fair values of a single identifiable asset, gross assets, and debt assumed in an acquisition transaction are $100, $150, and $50, respectively. Comparing the $100 asset with the $150 in gross assets indicates that substantially all of the fair value does not reside in a single asset. Therefore, the screen test is not met, and further evaluation is required to determine whether the set of acquired net assets is a business or should be accounted for as an asset acquisition.

In contrast, if the $100 fair value of the single identifiable asset is compared with $100 in net assets (an amount that has been reduced by debt), an entity would incorrectly conclude that the screen test has been met, because it would appear that all of the fair value resides in the single asset when, in fact, the fair value of the single identifiable asset is only two-thirds of the total assets acquired.

3.2 The framework: If the screen is not met

The guidance in ASC 805 requires an acquired set of net assets to meet the definition of a business in order for an entity to apply the acquisition method of accounting. If an acquired set does not meet the screen, the entity should then apply the framework outlined in ASC 805-10-55 to determine whether the acquired set is a business.

3.2.1 The framework: Elements of a business

The framework in ASC 805-10-55 states that a business is an integrated set of activities and assets that is capable of being conducted and managed in a manner that would generate economic returns for the investors or other owners, members, or participants. That guidance further stipulates that a business generally consists of three elements: input(s), processes applied to those input(s), and output(s), although output is not required for an integrated set to qualify as a business. Therefore, to be considered a business under the framework, the acquired set must include, at a minimum, an input and a substantive process that together significantly contribute to the acquired set's ability to create output.

ASC 805-10-55-4 defines "inputs" as economic resources that can create or contribute to the creation of outputs when one or more processes are applied to them. Inputs in an acquired set of net assets generally would consist of long-lived assets, including rights to use both long-lived assets as well as intangible assets, such as trade names, patents, customer-related intangibles, the ability to obtain access to necessary materials or rights (for example, distribution rights, franchise rights, broadcast rights, mineral rights, or supply contracts), and employees.

The guidance in ASC 805-10-55-4 defines "processes" as systems, standards, protocols, conventions, or rules that, when applied to inputs, can create or contribute to the creation of outputs. Only processes that are or can be used to create outputs are considered processes. Therefore, accounting, billing, payroll, and other administrative systems are generally not considered processes.

Processes are generally documented, but the acquiree is not required to have documented processes, since the presence of an input in the form of an organized workforce with the necessary skills and experience would generally provide the necessary processes that are capable of creating outputs. Examples of processes include

- *Strategic management processes* – Setting the overall objective and direction of the acquired set
- *Operational processes* – Developing or producing outputs and acquiring customers
- *Resource management processes* – Deploying and managing inputs

The definition of an "output" is generally consistent with how "outputs" are used in the revenue guidance in ASC 606 (that is, goods or services provided to customers). However, investment income and other forms of revenue outside the scope of ASC 606 are also included in the definition of an output in ASC 805.

In determining whether a set constitutes a business, it is not relevant whether the seller operated the acquired set of net assets as a business in the past or whether the acquirer intends to operate the acquired set as a business in the future. Rather, this determination should be based on whether the integrated set of assets is capable of being conducted and managed as a business by a market participant. This is an important distinction because, in some acquisitions, the acquirer may intend to split up the acquired set of net assets into separate components and to integrate certain components into its existing businesses. An acquirer in such circumstances should consider how a market participant might conduct and manage the acquired set of net assets, which requires judgment and might differ from how the acquirer intends to conduct and manage the acquired set.

ASC 805-10-55-3A

A business is 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. To be considered a business, an integrated set must meet the requirements in paragraphs 805-10-55-4 through 55-6 and 805-10-55-8 through 55-9.

ASC 805-10-55-4

A business consists of inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business. The three elements of a business are defined as follows:

a. Input. Any economic resource that creates, or has the ability to contribute to the creation of, outputs when one or more processes are applied to it. Examples include long-lived assets (including intangible assets or rights to use long-lived assets), intellectual property, the ability to obtain access to necessary materials or rights, and employees.

b. Process. Any system, standard protocol, convention, or rule that when applied to an input or inputs, creates or has the ability to contribute to the creation of outputs. Examples include strategic management processes, operational processes, and resource management processes. These processes are typically documented, but the intellectual capacity of an organized workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. Accounting, billing, payroll, and other administrative systems typically are not processes used to create outputs.

c. Output. The result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues.

ASC 805-10-55-5

To be capable of being conducted and managed for the purposes described in paragraph 805-10-55-3A, an integrated set of activities and assets requires two essential elements—inputs and processes applied to those inputs. A business need not include all the inputs or processes that the seller used in operating that business. However, to be considered a business, the set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output. Paragraphs 805-10-55-5A through 55-5C provide a practical screen to determine when a set would not be considered a business. If the screen is not met, further assessment is necessary to determine whether the set is a business. Paragraphs 805-10-55-5D through 55-6 and 805-10-55-8 through 55-9 provide a framework to assist an entity in evaluating whether the set includes both an input and a substantive process.

ASC 805-10-55-6

The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes, and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities,

but a business need not have liabilities. In addition, some transferred sets of assets and activities that are not a business may have liabilities.

ASC 805-10-55-8

Determining whether a particular set of assets and activities is a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. 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.

A set might include inputs and processes, but might lack outputs because the seller has not yet produced a product that is capable of being sold (for example, an entity with no revenue that is developing a prescription drug or a software product that is designed to generate revenue in the future). Although outputs are not required for a set to qualify as a business, outputs generally are an important element in any business. As a result, the framework requires more stringent criteria for an acquired set without outputs, such as a pre-revenue entity, to meet the definition of a business.

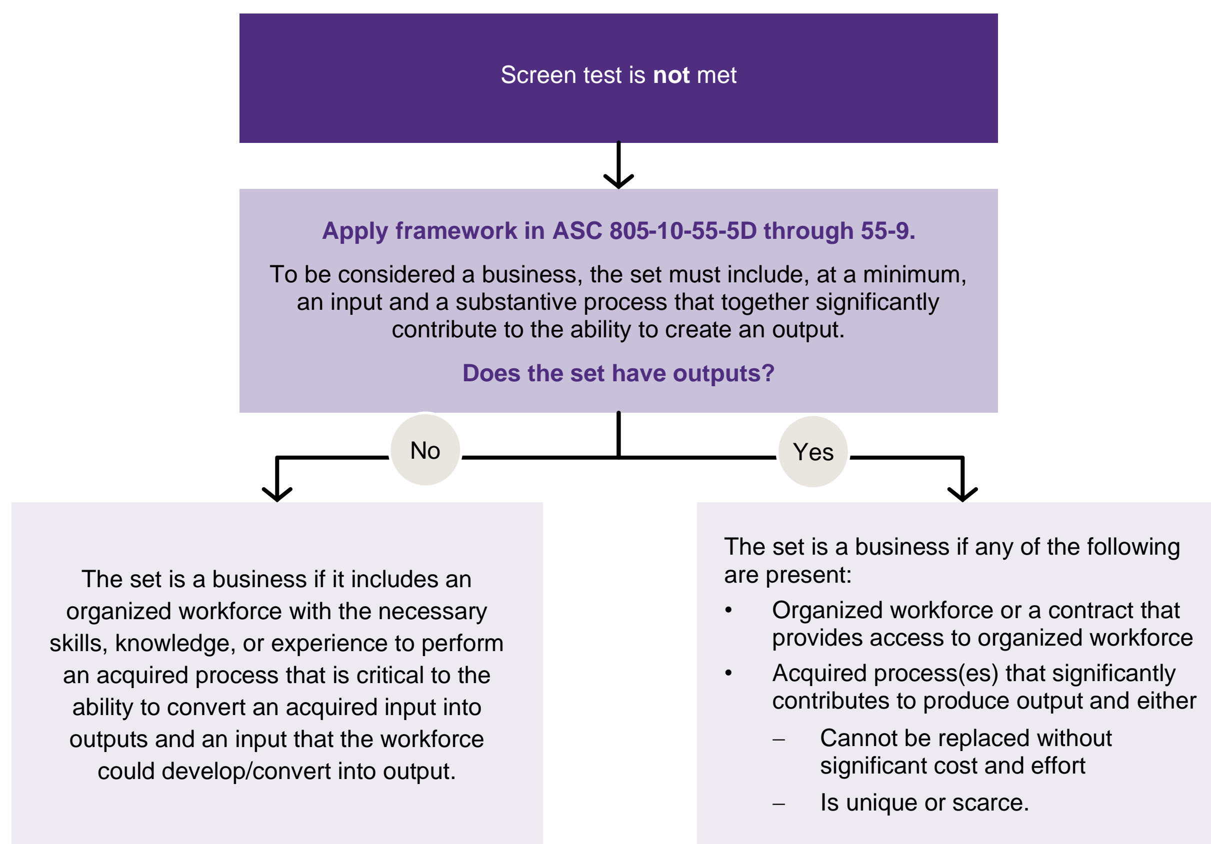
Grant Thornton insights: Acquired set with insignificant outputs

The guidance in ASC 805-10-55 includes two different sets of criteria to evaluate whether an acquired set of net assets includes both an input and a substantive process that together can significantly contribute to the ability to create outputs. Which set of criteria applies depends on whether the acquired set has outputs. If an acquired set produces an insignificant amount of output, an acquirer should apply judgment to determine the set of criteria that should be applied to assess whether the set is a business.

We believe that it is generally appropriate to evaluate the significance of the amount of output in relation to the fair value of the gross assets in the acquired set and, if the output is insignificant in relation to that fair value, to evaluate the set under the criteria applicable to an asset set without outputs.

Figure 3.3, which is a continuation of the flowchart in Figure 3.2, outlines the application of the framework that must be applied once it has been determined that the screen has not been met.

Figure 3.3: Screen test is not met



3.2.2 The framework: Set without output

When an acquired set does not produce outputs, it is considered to include both an input and a substantive process only if the set includes both

1. Employees with the necessary skills, knowledge, or experience to perform an acquired process (or a group of processes) that is critical to develop or convert the acquired input or inputs into outputs
2. Inputs such as intellectual property, mineral rights, or in-process research and development that the workforce could develop or convert into outputs

Grant Thornton insights: Evaluating outsourced workforce as a substantive process

In BC47 in ASU 2017-01, the FASB stated that in order to conclude that a substantive process exists, an acquired set without outputs should include an organized workforce that is made up of employees. Therefore, a contract with a vendor to provide access to an outsourced workforce that is part of the acquired set does not constitute a substantive process. We believe that the definition of “employee” in ASC 718 should be considered in determining whether an acquired organized workforce includes employees. The Board noted in BC47 in ASU 2017-01 that there are inherent limitations on the

processes that can be performed in a development capacity without further decision-making or actions from an employee needed to manage the vendor's performance.

If the acquired set includes both employees and an outsourced workforce, entities must apply judgment in determining whether the employees have the necessary skills critical to performing processes used to convert the acquired input(s) into output(s) in order to conclude that a substantive process has been acquired.

The acquired inputs evaluated for determining whether an acquired set of net assets is a business should be substantive as well as integral to the acquired processes in creating outputs. Therefore, ancillary assets, such as office furniture in an acquired set that focuses on developing medical equipment, should not be considered an input for determining whether the acquired set is a business.

ASC 805-10-55-5D

When a set does not have outputs (for example, an early stage company that has not generated revenues), the set will have both an input and a substantive process that together significantly contribute to the ability to create outputs only if it includes employees that form an organized workforce and an input that the workforce could develop or convert into output. The organized workforce must 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 entity should consider the following in evaluating whether the acquired workforce is performing a substantive process:

a. 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.

b. Inputs that employees who form an organized workforce could develop (or are developing) or convert into outputs could include the following:

    1. Intellectual property that could be used to develop a good or service

    2. Resources that could be developed to create outputs

    3. 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.

3.2.3 The framework: Set with output

When the acquired set has outputs (that is, there is a continuation of revenue both before and after the transaction), the set is considered to have both an input and a substantive process and, as a result, is a business if the set has any one of the following attributes:

- Employees that form an organized workforce with the necessary skills, knowledge, or experience to perform an acquired process that, when applied to an acquired input(s), is critical to continue producing outputs. The guidance in ASC 805-10-55-5E indicates that the "intellectual capacity" (the necessary skills, knowledge, or experience) of the employees who form an organized workforce is important in determining whether a substantive process exists in the set, because the existence of

any employee would not indicate that a set with outputs is a business. That guidance further indicates that a process is not “critical” if it is ancillary or minor when considered within the context of all of the processes required to continue producing outputs.

- An acquired contract that provides access to an organized workforce with the necessary skills, knowledge, or experience to perform an acquired process that, when applied to an acquired input or inputs, is critical to the ability to continue producing outputs.
- The acquired process (or processes) that, when applied to an acquired input or inputs, significantly contributes to the ability to continue producing outputs and both (1) cannot be replaced without significant cost, effort, or delay, and (2) is considered unique or scarce.

Even if an acquired set has outputs, the continued generation of revenue does not, on its own, indicate that the set contains a substantive process. In this situation, an entity would still be required to evaluate whether the acquired set contains a substantive process based on the presence of any of the factors described in the bullets above. Therefore, assumed contractual arrangements that continue to generate revenue, such as customer contracts, customer lists, and leases (when the acquired set is a lessor), should be excluded from the analysis of whether the acquired set has a substantive process.

If, however, the acquired set also includes an assumed contract that provides access to an organized workforce that performs the process(es) critical to the continued generation of revenue, the set might include a substantive process and therefore constitute a business. For example, the seller might operate the set by contracting with a third party that provides an organized workforce. If the acquirer assumes the seller’s existing management contract, the set might include a substantive process. In contrast, an acquirer that uses its own workforce or utilizes an existing management contract to provide the workforce would not include a substantive process because the workforce is not acquired as part of the set.

ASC 805-10-55-5E

When the set has outputs (that is, there is 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:

a. Employees that form 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. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all of the processes required to continue producing outputs.

b. 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).

c. 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.

d. 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.

ASC 805-10-55-5F

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 paragraph 805-10-55-5E of whether a process has been acquired.

3.2.4 The framework: Presence of more than insignificant goodwill

When applying the framework to identify whether an acquired set is a business, the presence of more than an insignificant amount of goodwill may be an indicator that a substantive process exists. Therefore, the presence of more than an insignificant amount of goodwill may help an acquirer to determine whether an organized workforce is performing a critical process and whether an acquired process is substantive in an acquired set with outputs.

However, the lack of goodwill in an acquired set is not determinative that the set is not a business. The FASB stated in paragraph BC57 of ASU 2017-01 that it did not intend for the evaluation of more than an insignificant amount of goodwill to be an additional step in determining whether an acquired set constitutes a business. Rather, the FASB intended the guidance simply to be another indicator in the acquirer's analysis.

ASC 805-10-55-9

When evaluating whether a set meets the criteria in paragraphs 805-10-55-5D through 55-5E, the presence of more than an insignificant amount of goodwill may be an indicator that the acquired process is substantive and, therefore, the acquired set is a business. However, a business need not have goodwill.

3.3 Illustrative examples: Identifying a business

Figure 3.4 summarizes the illustrations in Example 6 in ASC 805-10-55 and indicates which guidance each example illustrates in determining whether an acquired set of net assets meets the definition of a business.

Figure 3.4: Summary of ASC 805 examples and guidance illustrated

Case	Case title	Acquired set	Single identifiable asset assessment	Similar asset assessment	Set without outputs	Set with outputs
A	Acquisition of real estate (Scenario 1)	A portfolio of single-family homes with in-place leases	X	X		
	Acquisition of real estate (Scenario 2)	In addition to the acquired set in Scenario 1, the acquired set also includes an office park leased to maximum occupancy, vendor contracts for outsourced cleaning, security, and maintenance	X	X		X
	Acquisition of real estate (Scenario 3)	In addition to the acquired set in Scenario 2, the acquired set also includes employees responsible for leasing, managing tenants, and managing and supervising all operational processes				X
B	Acquisition of a drug candidate (Scenario 1)	In-process research and development (IPR&D) project, at-market clinical research organization, and manufacturing organization contracts	X			
	Acquisition of a drug candidate (Scenario 2)	Two separate IPR&D projects, at-market clinical research organization, and manufacturing organization contracts	X	X	X	

Case	Case title	Acquired set	Single identifiable asset assessment	Similar asset assessment	Set without outputs	Set with outputs
C	Acquisition of biotech	R&D activities on several drug compounds in development phase to treat different diseases, including senior management, scientists, and long-lived tangible assets		X	X	
D	Acquisition of a television station	FCC license, broadcasting equipment, and office building	X	X	X	
E	Acquisition of a manufacturing facility	Equipment, facility (land and buildings), and employees	X	X	X	
F	License of distribution rights	License to distribution rights of product, customer contracts, and a supply agreement	X	X		X
G	Acquisition of brands	Worldwide rights of brand, related IP, customer contracts and relationships, finished goods inventory, marketing materials, customer incentive programs, raw material supply contracts, specialized equipment, and documented processes and protocols to produce product	X	X		X
H	Acquisition of loan portfolio (Scenario 1)	Loan portfolio with not significantly different terms, size, and risk ratings of the loans		X		

Case	Case title	Acquired set	Single identifiable asset assessment	Similar asset assessment	Set without outputs	Set with outputs
	Acquisition of loan portfolio (Scenario 2)	Loan portfolio with significantly different terms, size, and risk ratings of the loans	X	X		X
	Acquisition of loan portfolio (Scenario 3)	Same as Scenario 2, except also acquires employees who managed credit risk of portfolio and relationship with borrowers	X	X		X

Case A: Acquisition of Real Estate

Scenario 1

ASC 805-10-55-52

ABC acquires, renovates, leases, sells, and manages real estate properties. ABC 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.

ASC 805-10-55-53

ABC first considers the threshold guidance in paragraphs 805-10-55-5A through 55-5C. ABC concludes that the land, building, property improvements, and in-place leases at each property can be considered a single asset in accordance with paragraph 805-10-55-5B. That is, the building and property improvements are attached to the land and cannot be removed without incurring significant cost. Additionally, the in-place lease is an intangible asset that should be combined with the related real estate and considered a single asset.

ASC 805-10-55-54

ABC also concludes that the 10 single assets (the combined land, building, in-place lease intangible, and property improvements) are similar. 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 are not significantly different. That is, the risks associated with operating the properties and tenant acquisition and management are not significantly different because the types of homes and class of customers are not significantly different. Similarly, the risks

associated with operating in the real estate market of the homes acquired are not significantly different. Consequently, ABC concludes that substantially all of the fair value of the gross assets acquired is concentrated in the group of similar identifiable assets; thus, the set is not a business.

Scenario 2

ASC 805-10-55-55

Assume the same facts as in Scenario 1 except that ABC also acquires an office park with six 10-story office buildings leased to maximum occupancy of which all have significant fair value. ABC also acquires the vendor contracts for outsourced cleaning, security, and maintenance. Seller's employees that perform leasing (sales, underwriting, and so forth), tenant management, financing, and other strategic management processes are not included in the set. ABC plans to replace the property management and employees with its own internal resources.

ASC 805-10-55-56

ABC concludes that the single-family homes and office park are not similar assets. ABC considers the risks associated with operating the assets, obtaining tenants, and tenant management between the single-family homes and office park to be significantly different because the scale of operations and risks associated with the class of customers are significantly different. Therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets. Thus, ABC must further evaluate whether the set has the minimum requirements to be considered a business.

ASC 805-10-55-57

The set has continuing revenues through the in-place leases and, therefore, has outputs. ABC must consider the criteria in paragraph 805-10-55-5E to determine whether the set includes both an input and a substantive process that together significantly contribute to the ability to create outputs.

ASC 805-10-55-58

ABC concludes that the criteria in paragraph 805-10-55-5E(a) through (b) are not met because the set does not include employees and the processes performed through the cleaning and security contracts (the only processes acquired) will be considered ancillary or minor in the context of all the processes required to create outputs in the real estate industry. That is, while those outsourcing agreements may be considered to provide an organized workforce that performs cleaning and security processes when applied to the building, the processes performed by the cleaning, security, and maintenance personnel are not considered critical in the context of all the processes required to create outputs.

ASC 805-10-55-59

ABC also concludes that the criterion in paragraph 805-10-55-5E(c) is not met because the cleaning and security processes could be easily replaced with little cost, effort, or delay in the ability to continue producing outputs. While the cleaning and security processes are necessary for continued operations of the buildings, these contracts can be replaced quickly with little effect on the ability to continue producing outputs.

ASC 805-10-55-60

ABC concludes that the criterion in paragraph 805-10-55-5E(d) is not met because the cleaning and security contracts are not considered unique or scarce. That is, these types of arrangements are readily accessible in the marketplace.

ASC 805-10-55-61

Because none of the criteria were met, ABC concludes that the set does not include both an input and substantive processes that together significantly contribute to the ability to create outputs and, therefore, is not considered a business.

Scenario 3

ASC 805-10-55-62

Assume the same facts as in Scenario 2, except that the set includes the employees responsible for leasing, tenant management, and managing and supervising all operational processes.

ASC 805-10-55-63

The set has continuing revenues through the in-place leases and, therefore, has outputs. ABC must consider the criteria in paragraph 805-10-55-5E to determine whether the set includes both an input and a substantive process that together significantly contribute to the ability to create outputs.

ASC 805-10-55-64

ABC determines that the criterion in paragraph 805-10-55-5E(a) is met because the set includes an organized workforce that performs processes that when applied to the acquired inputs in the set (the land, building, and in-place leases) are critical to the ability to continue producing outputs. That is, ABC concludes that the leasing, tenant management, and supervision of the operational processes are critical to the creation of outputs. Because it includes both an input and a substantive process, the set is considered a business.

Case B: Acquisition of a Drug Candidate

Scenario 1

ASC 805-10-55-65

Pharma Co. purchases from Biotech a legal entity that contains the rights to a Phase 3 (in the clinical research phase) compound being developed to treat diabetes (the in-process research and development project). Included in the in-process research and development 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.

ASC 805-10-55-66

Pharma Co. first considers the guidance in paragraphs 805-10-55-5A through 55-5C. Pharma Co. concludes that the in-process research and development 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. As such, Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is concentrated in the single in-process research and development asset and the set is not a business.

Scenario 2

ASC 805-10-55-67

Pharma Co. purchases from Biotech a legal entity that contains the rights to a Phase 3 compound being developed to treat diabetes (Project 1) and a Phase 3 compound being developed to treat Alzheimer's disease (Project 2). Included with each project are 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 at-market clinical research organization contracts and at-market clinical manufacturing organization contracts associated with each project. Assume that Project 1 and Project 2 have equal fair value. No employees, other assets, or other activities are transferred.

ASC 805-10-55-68

Pharma Co. concludes that Project 1 and Project 2 are each separately identifiable intangible assets, both of which would be accounted for as a single asset in a business combination. Pharma Co. then considers whether Project 1 and Project 2 are similar assets. Pharma Co. notes that the nature of the assets is similar in that both Project 1 and Project 2 are in-process research and development assets in the same major asset class. However, Pharma Co. concludes that Project 1 and Project 2 have significantly different risks associated with creating outputs from each asset because each project has different risks associated with developing and marketing the compound to customers. The projects are intended to treat significantly different medical conditions, and each project has a significantly different potential customer base and expected market and regulatory risks associated with the assets. Thus, Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and that it must further evaluate whether the set has the minimum requirements to be considered a business.

ASC 805-10-55-69

Because the set does not have outputs, Pharma Co. evaluates the criteria in paragraph 805-10-55-5D to determine whether the set has both an input and a substantive process that together significantly contribute to the ability to create outputs. Pharma Co. concludes that the criteria are not met because the set does not have employees. As such, Pharma Co. concludes that the set is not a business.

Case C: Acquisition of Biotech

ASC 805-10-55-70

Pharma Co. buys all of the outstanding shares of Biotech. Biotech's operations include research and development activities on several drug compounds that it is developing (in-process research and development projects). The in-process research and development projects are in different phases

of the U.S. Food and Drug Administration approval process and would treat significantly different diseases. The set includes senior management and scientists that have the necessary skills, knowledge, or experience to perform research and development activities. In addition, Biotech has long-lived tangible assets such as a corporate headquarters, a research lab, and lab equipment. Biotech does not yet have a marketable product and, therefore, has not generated revenues. Assume that each research and development project has a significant amount of fair value.

ASC 805-10-55-71

Pharma Co. first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The identifiable assets in the set include multiple in-process research and development projects and tangible assets (the corporate headquarters, the research lab, and the lab equipment). Pharma Co. concludes that the in-process research and development projects are not similar assets because the projects have significantly different risks associated with managing the assets and creating the outputs (that is, because there are significantly different development risks in the different phases of development, market risks related to the different customer base, and potential markets for the compounds). In addition, Pharma Co. concludes that there is fair value associated with the acquired workforce because of the proprietary knowledge of and experience with Biotech's ongoing development projects and the potential for creation of new development projects that the workforce embodies. As such, Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and that it must further evaluate whether the set has the minimum requirements to be considered a business.

ASC 805-10-55-72

Because the set does not have outputs, Pharma Co. evaluates the criteria in paragraph 805-10-55-5D to determine whether the set has both an input and a substantive process that together significantly contribute to the ability to create outputs. Pharma Co. concludes that the criteria are met because the scientists make up an organized workforce that has the necessary skills, knowledge, or experience to perform processes that when applied to the in-process research and development inputs is critical to the ability to develop those inputs into a product that can be provided to a customer. Pharma Co. also determines that there is a more-than-insignificant amount of goodwill (including the fair value associated with the workforce), which is another indicator that the workforce is performing a critical process. Thus, the set includes both inputs and substantive processes and is a business.

Case D: Acquisition of a Television Station

ASC 805-10-55-73

Company A is a television broadcaster whose principal business is the ownership and operation of a television station group in the United States through which it broadcasts its proprietary health-care-related programming. Company B owns and operates several television stations in the western United States. Because of a recent merger, Company B must divest itself of a station in Portland, Oregon (KPOR), and agrees to sell the station to Company A.

ASC 805-10-55-74

Company A plans to change KPOR's programming format to its proprietary health-care-related 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.

ASC 805-10-55-75

Company A first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The U.S. Federal Communications Commission license is an intangible asset that is recognized and measured separately in a business combination, while the broadcast equipment and building are tangible nonfinancial assets in different major classes. Company A concludes that the broadcast equipment and building are not considered a single asset because the equipment is not attached to the building and can be removed without significant cost or diminution in fair value. Furthermore, none of the assets will be considered similar in accordance with paragraph 805-10-55-5C because the U.S. Federal Communications Commission license cannot be considered similar to tangible assets and the tangible assets are in different major asset classes. Each of the separate identifiable assets has significant fair value. Thus, Company A concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and that it must further evaluate whether the set has the minimum requirements to be considered a business.

ASC 805-10-55-76

The set does not have outputs; therefore, Company A considers the criteria in paragraph 805-10-55-5D to determine whether the set includes both an input and a substantive process that together significantly contribute to the ability to create outputs. The set does not include an organized workforce, so it does not meet the criteria in paragraph 805-10-55-5D. Therefore, the set does not include both an input and a substantive process and is not considered a business.

Case E: Acquisition of a Manufacturing Facility

ASC 805-10-55-77

Widget Co. manufactures complex equipment and has manufacturing facilities throughout the world. Widget Co. decided to idle a facility in a foreign jurisdiction in a reorganization of its manufacturing footprint and furloughed the assembly line employees.

ASC 805-10-55-78

Acquirer enters into an agreement to purchase a manufacturing facility and related equipment from Widget Co. To comply with the local labor laws, Acquirer also must assume the furloughed employees.

ASC 805-10-55-79

The assets acquired include the equipment and facility (land and building) but no intellectual property, inventory, customer relationships, or any other inputs.

ASC 805-10-55-80

Acquirer first considers the guidance in paragraphs 805-10-55-5A through 55-5C. Acquirer concludes that the equipment in the facility can be removed without significant cost or diminution in utility or

fair value because the equipment is not attached to the building and can be used in many types of manufacturing facilities. Therefore, the equipment and building are not a single asset. Furthermore, the equipment and facility are not considered similar assets because they are different major classes of tangible assets. Acquirer determines that there is significant fair value in both the equipment and the facility and, thus, concludes that it must further evaluate whether the set has the minimum requirements to be considered a business.

ASC 805-10-55-81

The set is not currently producing outputs because there is no continuation of revenue before and after the transaction; therefore, Acquirer considers the criteria in paragraph 805-10-55-5D and 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 criteria in paragraph 805-10-55-5D. That is, the equipment itself cannot be developed or converted into an output by those employees. Therefore, the set is not a business.

Case F: License of Distribution Rights

ASC 805-10-55-82

Company A is a distributor of food and beverages. Company A enters into an agreement to sublicense the Latin American distribution rights of Yogurt Brand F to Company B, whereby Company B will distribute Yogurt Brand F in Latin America. As part of the agreement, Company A transfers the existing customer contracts in Latin America to Company B and an at-market supply contract with the producer of Yogurt Brand F. Company A retains all of its employees and distribution capabilities.

ASC 805-10-55-83

Company B first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The identifiable assets that could be recognized in a business combination include the license to distribute Yogurt Brand F, customer contracts, and the supply agreement. Company B concludes that the license and customer contracts will have fair value assigned to them. Company B concludes that neither asset represents substantially all of the fair value of the gross assets. Company B then considers whether the license and customer contracts are a group of similar intangible assets. Because the license and customer contracts are in different major classes of identifiable intangible assets, they are not considered similar assets. Therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets, and Company B must evaluate whether the set has both an input and a substantive process.

ASC 805-10-55-84

The set has outputs through the continuation of revenues with customers in Latin America. As such, Company B must evaluate the criteria in paragraph 805-10-55-5E to determine 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. The set is not a business because:

a. It does not include an organized workforce that could meet the criteria in paragraph 805-10-55-5E(a) through (b).

b. There are no acquired processes that could meet the criteria in paragraph 805-10-55-5E(c) through (d).

c. It does not include both an input and a substantive process.

Case G: Acquisition of Brands

ASC 805-10-55-85

Company A is a global producer of food and beverages. Company A sells the worldwide rights of Yogurt Brand F, including all related intellectual property, to Company B. Company B also acquires all customer contracts and relationships, finished goods inventory, marketing materials, customer incentive programs, raw material supply contracts, specialized equipment specific to manufacturing Yogurt Brand F, and documented processes and protocols to produce Yogurt Brand F. Company B does not receive employees, manufacturing facilities, all of the manufacturing equipment and processes required to produce the product, and distribution facilities and processes.

ASC 805-10-55-86

Company B first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The gross assets include intellectual property (the trademark, the related trade name, and recipes) associated with Yogurt Brand F (the intellectual property associated with the brand is determined to be a single intangible asset in accordance with the guidance in paragraph 805-20-55-18), customer contracts and related relationships, equipment, finished goods inventory, and the excess of the consideration transferred over the fair value of the net assets acquired. Company B concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets even though, for purposes of the analysis, the intellectual property is considered to be a single identifiable asset. In addition, because there is significant fair value in both tangible assets and intangible assets, Company B concludes that there is not a group of similar assets that meets this threshold.

ASC 805-10-55-87

The set has outputs through the continuation of revenues, and Company B must consider the criteria in paragraph 805-10-55-5E to determine whether the set includes both inputs and a substantive process that together significantly contribute to the ability to create outputs. The set does not include an organized workforce and, therefore, does not meet the criteria in paragraph 805-10-55-5E(a) through (b). However, the acquired manufacturing processes are unique to Yogurt Brand F, and when those processes are applied to acquired inputs such as the intellectual property, raw material supply contracts, and the equipment, they significantly contribute to the ability to continue producing outputs. As such, the criterion in paragraph 805-10-55-5E(c) is met, and the set includes both inputs and substantive processes. Because the set includes inputs and substantive processes that together significantly contribute to the ability to create outputs, it is considered a business.

Case H: Acquisition of Loan Portfolio

Scenario 1

ASC 805-10-55-88

Bank A purchases a loan portfolio from Bank Z. The portfolio of loans consists of residential mortgages with terms, size, and risk ratings that are not significantly different. Bank A does not take over the employees of Bank Z that managed the credit risk of the portfolio and the relationship with the borrowers (such as brokers, vendors, and risk managers).

ASC 805-10-55-89

Bank A first considers the guidance in paragraphs 805-10-55-5A through 55-5C. Bank A concludes that the nature of the assets (residential mortgage loans) is similar. Bank A also concludes that the risks associated with managing and creating outputs are not significantly different because the terms, size, and risk ratings of the loans are not significantly different. Because all of the fair value of the gross assets acquired is in a group of similar identifiable assets, the set is not a business.

Scenario 2

ASC 805-10-55-90

Assume the same facts as in Scenario 1 except that the portfolio of loans consists of commercial loans with term, size, and risk ratings that are significantly different.

ASC 805-10-55-91

Bank A first considers the guidance in paragraphs 805-10-55-5A through 55-5C. Bank A must consider whether the loans are similar. Bank A concludes that the nature of the assets (commercial loans) is similar; however, because the term, size, and risk ratings of the loans are significantly different, Bank A concludes that the risks associated with managing and creating outputs are significantly different. Thus, Bank A concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and that it must further evaluate whether the set has the minimum requirements to be considered a business.

ASC 805-10-55-92

The set has outputs through the continuation of revenues (interest income). Consequently, Bank A considers the criteria in paragraph 805-10-55-5E to determine whether the set includes both inputs and a substantive process that together significantly contribute to the ability to create outputs. Because the set does not include an organized workforce or acquired processes, the criteria in paragraph 805-10-55-5E are not met and the set is not a business.

Scenario 3

ASC 805-10-55-93

Assume the same facts as in Scenario 2 except that Bank A takes over the employees of Bank Z that managed the credit risk of the portfolio and the relationship with the borrowers (such as brokers and

risk managers). Additionally, consideration transferred is significantly higher than Bank A's estimate of the fair value of the loan portfolio.

ASC 805-10-55-94

Bank A first considers the guidance in paragraphs 805-10-55-5A through 55-5C. Bank A concludes that the loan portfolio does not consist of similar identifiable assets. Bank A also concludes that there is significant fair value associated with different groups of financial assets and the acquired workforce. As such, Bank A concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and that it must further evaluate whether the set has met the minimum requirements to be considered a business.

ASC 805-10-55-95

The set has outputs through the continuation of revenues (interest income). Consequently, Bank A considers the criteria in paragraph 805-10-55-5E to determine whether the set includes both an input and a substantive process that together significantly contribute to the ability to create outputs.

ASC 805-10-55-96

Bank A evaluates the criteria in paragraph 805-10-55-5E and concludes that the criterion in paragraph 805-10-55-5E(a) is met because the set includes an organized workforce that performs processes (customer relationship management and credit risk management) critical to the ability to continue producing outputs; therefore, the set is a business.

4. Transactions not considered business combinations

There are many transactions that have characteristics of a business combination but are outside the scope of business combination accounting in ASC 805. As such, an entity should consider the scope of ASC 805 to determine which transactions or events should be accounted for using the guidance in another Codification Topic.

ASC 805-10-15-4

The guidance in the Business Combinations Topic does not apply to any of the following:

a. The formation of a joint venture

b. The acquisition of an asset or a group of assets that does not constitute a business or a nonprofit activity

c. A combination between entities, businesses, or nonprofit activities under common control (see paragraph 805-50-15-6 for examples)

d. An acquisition by a not-for-profit entity for which the acquisition date is before December 15, 2009 or a merger of not-for-profit entities (NFPs)

e. A transaction or other event in which an NFP obtains control of a not-for-profit entity but does not consolidate that entity, as described in paragraph 958-810-25-4. The Business Combinations Topic also does not apply if an NFP that obtained control in a transaction or other event in which consolidation was permitted but not required decides in a subsequent annual reporting period to begin consolidating a controlled entity that it initially chose not to consolidate.

f. Financial assets and financial liabilities of a consolidated variable interest entity that is a collateralized financing entity within the scope of the guidance on collateralized financing entities in Subtopic 810-10.

4.1 Formation of a joint venture

The formation of a joint venture is not accounted for under the business combination guidance. One criterion in identifying a joint venture is that the joint venturers must jointly control the overall management of the joint venture. However, the SEC staff has clarified in ASC 805-10-S99-8 that joint control should not be considered a determinative criterion in identifying a joint venture and that entities should consider all the characteristics included in the definition of a “corporate joint venture.”

Corporate Joint Venture: A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture.

ASC 805-10-S99-8

Comments Made by SEC Observer at EITF Meetings

The following is the text of SEC Observer Comment: Accounting by a Joint Venture for Businesses Received at Its Formation.

- The SEC staff will object to a conclusion that did not result in the application of Topic 805 to transactions in which businesses are contributed to a newly formed, jointly controlled entity if that entity is not a joint venture. The SEC staff also would object to a conclusion that joint control is the only defining characteristic of a joint venture.

4.2 Acquisitions not meeting definition of business or not-for-profit activity

The acquisition of an asset (or a group of activities and assets) that does not meet the definition of a business or not-for-profit activity is not considered a business combination. The guidance for such transactions is included in ASC 805-50, which is not covered in this publication. For a discussion on the definition of a “business,” refer to Section 3.

4.3 Transactions between entities under common control

Transactions between entities under common control are not considered business combinations because the net assets transferred remain under the control of the parent. In other words, there is no change in control in these types of transactions. The guidance to account for such transactions is included in ASC 805-50. ASC 805-50-15-6 includes examples of these types of transactions.

ASC 805-50-15-6

The guidance in the Transactions between Entities under Common Control Subsections applies to combinations between entities or businesses under common control. The following are examples of those types of transactions:

a. An entity charters a newly formed entity and then transfers some or all of its net assets to that newly chartered entity.

b. A parent transfers the net assets of a wholly owned subsidiary into the parent and liquidates the subsidiary. That transaction is a change in legal organization but not a change in the reporting entity.

c. A parent transfers its controlling interest in several partially owned subsidiaries to a new wholly owned subsidiary. That also is a change in legal organization but not in the reporting entity.

d. A parent exchanges its ownership interests or the net assets of a wholly owned subsidiary for additional shares issued by the parent's less-than-wholly-owned subsidiary, thereby increasing the parent's percentage of ownership in the less-than-wholly-owned subsidiary but leaving all of the existing noncontrolling interest outstanding.

e. A parent's less-than-wholly-owned subsidiary issues its shares in exchange for shares of another subsidiary previously owned by the same parent, and the noncontrolling shareholders are not party to the exchange. That is not a business combination from the perspective of the parent.

f. A limited liability company is formed by combining entities under common control.

g. Two or more not-for-profit entities (NFPs) that are effectively controlled by the same board members transfer their net assets to a new entity, dissolve the former entities, and appoint the same board members to the newly combined entity.

4.4 Not-for-profit entities

The guidance on business combinations in ASC 805 excludes transactions in which not-for-profit entities are required to apply merger accounting (that is, carryover basis) in accordance with ASC 958-805 and those in which a not-for-profit entity obtains control of another not-for-profit entity but does not consolidate the acquired not-for-profit entity, as described in ASC 958-810-25-4.

In addition, a not-for-profit entity should not apply the business combination guidance to transactions where it obtains control and chooses not to consolidate the acquiree at the acquisition date, but decides in a subsequent annual reporting period to begin consolidating the controlled entity.

4.5 Collateralized financing entities

The business combination guidance does not apply to the financial assets and financial liabilities of a consolidated VIE that is a collateralized financing entity within the scope of the guidance on collateralized financing entities in ASC 810-10.

Collateralized Financing Entity: A **variable interest entity** that holds financial assets, issues **beneficial interests** in those financial assets, and has no more than nominal equity. The beneficial interests have contractual recourse only to the related assets of the collateralized financing entity and are classified as financial liabilities. A collateralized financing entity may hold **nonfinancial assets** temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the collateralized financing entity or in an effort to restructure the debt instruments held as assets by the collateralized financing entity. A collateralized financing entity also may hold other financial assets and

financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).

Appendix

The following table contains the titles of guidance cited in this publication from both the FASB's Accounting Standards Codification (ASC) and relevant Accounting Standards Updates (ASUs), as well as titles of guidance issued by the SEC.

Quick reference	Title
ASC 606	*Revenue from Contracts with Customers*
ASC 718	*Compensation – Stock Compensation*
ASC 805	*Business Combinations*
ASC 810	*Consolidations*
ASC 842	*Leases*
ASC 958	*Not-for-Profit Entities*
ASU 2017-01	*Clarifying the Definition of a Business*
SEC Regulation S-X	*Form and Content of and Requirements for Financial Statements*
Article 11 of SEC Regulation S-X	*Pro-Forma Financial Information*
Rule 11-01(d) of SEC Regulation S-X	*Presentation requirements*

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