



Ernst & Young LLP
5 Times Square
New York, NY 10036

Tel: +1 212 773 3000
ey.com

2015-330
Comment Letter No. 5

Ms. Susan M. Cospers
Technical Director
File Reference No. 2015-330
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

21 January 2016

Proposed Accounting Standards Update, *Business Combinations (Topic 805): Clarifying the Definition of a Business* (File Reference No. 2015-330)

Dear Ms. Cospers:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Business Combinations (Topic 805), Clarifying the Definition of a Business* (the Proposal), issued by the Financial Accounting Standards Board (FASB or Board).

We support the FASB's objective of adding guidance to help entities evaluate whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. In proposing these amendments, the FASB is responding to concerns raised by constituents that the current definition of a business is too broad and can be challenging to apply. Overall, we believe that the proposed amendments would simplify the evaluation of whether a set of assets and activities (set) meets the definition of a business. However, we recommend that the Board consider amending certain language and clarifying some of the examples in the Proposal.

In particular, we believe the proposed "substantially all" threshold would allow entities to determine relatively quickly that certain sets are not businesses and reduce the need to perform a more fulsome evaluation in those cases. We also believe the proposed framework to determine whether a set includes a substantive process would help entities arrive at appropriate conclusions about the substance of a transaction because processes are an important element that distinguishes a business from an asset.

While we support the Proposal, we believe the Board should further mitigate the diversity in practice that will continue to arise from the judgments in applying the definition by reducing or eliminating the differences between the accounting for acquisitions (or dispositions) of businesses and assets. We encourage the Board to do this when it evaluates these differences in a later phase of the project.

Finally, we commend the FASB on its efforts to work with the International Accounting Standards Board (IASB) on its similar project on clarifying the definition of a business. We encourage continued engagement with the IASB because we believe that maintaining convergence in the business combinations standards in US GAAP and IFRS would improve consistency in the application of judgment across entities and industries globally.



The appendix to this letter contains our responses to certain questions posed in the Proposal.

* * * * *

We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,

Ernst & Young LLP

**Appendix – Responses to questions raised in the Proposed Accounting Standards Update,
*Business Combinations (Topic 805): Clarifying the Definition of a Business***

Question 1: Do you agree that to be a business a set of assets and activities must include, at a minimum, an input and a substantive process that together contribute to the ability to create outputs? If not, what other alternatives would you suggest?

We agree with the Proposal that to be a business a set must include, at a minimum, an input and a substantive process that together contribute to the ability to create outputs. We agree with the Board that the existence of a substantive process (or processes) distinguishes a business from an asset.

While we support this aspect of the Proposal, we believe that such a requirement would increase the significance of evaluating which items are part of, or separate from, the set. For example, if an acquirer does not assume employees or outsourcing arrangements from a seller but enters into a new outsourcing arrangement at the same time as the acquisition, an entity would have to evaluate whether the new arrangement is an element of the acquired set. We suggest that the guidance on the definition of a business refer to Accounting Standards Codification (ASC) 805-10-55-18, which provides guidance on determining whether a transaction is part of a business combination or should be accounted for separately, and state that any inputs or processes provided through separate transactions would be excluded from the analysis of whether the set meets the definition of a business.

We believe significant judgment is required when applying the guidance in ASC 805-10-55-18. For example, in Case F in the Proposal, significant judgment is necessary to determine which party primarily benefits from the supply contract entered into contemporaneously with the acquisition. In this example, the acquirer enters into an at-market supply contract with the seller at the same time it enters into the license agreement and obtains the customer contracts. Proposed paragraph 805-10-55-71 indicates that the acquirer would consider the supply contract as one of the identifiable assets that could be recognized in a business combination.

Without further explanation in the example, it's not clear why the supply contract would be deemed part of the business combination. The supply contract could be viewed as primarily benefiting the acquirer or the combined entity rather than primarily benefiting the acquiree or its former owners. If that's the case, we do not believe the supply contract would be considered in the evaluation of whether the acquired set meets the definition of a business. In the proposed example, the supply agreement is considered an input rather than a process and therefore does not affect the conclusion. However, we believe that, in some cases, similar contracts could result in the set having a substantive process and meeting the definition of a business. We therefore believe it would be helpful for the FASB to explain in Case F whether the supply agreement is considered part of the acquired set and how the factors in ASC 805-10-55-18 were evaluated in reaching that conclusion.

Question 2: Paragraphs 805-10-55-5A through 55-5D provide guidance on determining whether a set contains an input and a substantive process that together contribute to the ability to create outputs. Are the criteria appropriate, and would they be operable in practice? If not, why?

We support adding criteria to determine whether a set contains an input and a substantive process and agree that the proposed criteria are appropriate indicators that a substantive process has been acquired and are operable in practice. We believe the criteria included in the Proposal would be helpful to both preparers and auditors in applying the definition and promote a more consistent application of the definition, but we do believe that amending certain language and clarifying some of the examples as described below could improve the operability of the Proposal.

The proposed criteria to be considered a business in paragraphs 805-10-55-5A and 805-10-55-5B – that is, “an input and a substantive process that together *contribute to the ability to create outputs*” – uses language that differs from the general criteria in ASC 805-10-55-4 and could lead to differences in interpretation. ASC 805-10-55-4 refers to “inputs and processes applied to those inputs that *have the ability to create outputs*.” As a result, we believe that some could conclude that “contributing” to the ability to create outputs is a lower threshold than “having” the ability to create outputs. That is, some could conclude that the overall set is not required to have the *ability to create outputs* if a substantive process is acquired that could *contribute to the ability to create outputs*.

We recommend that the Board consider changing the words in proposed paragraphs 805-10-55-5A and 805-10-55-5B to state that the set must include an input and a substantive process that *have the ability to create outputs* to be consistent with the overall criteria of the definition of a business in ASC 805-10-55-4.

We also recommend that the Board consider changing proposed Case E because it is unclear why the Board believes the set has the ability to create outputs and is a business. Proposed paragraph 805-10-55-67 states that the operations of the acquiree include research and development activities on several preclinical compounds. Compounds in the preclinical stage represent a very early stage in the development of a drug with a relatively low success rate in obtaining approval by the Food and Drug Administration. Many entities today would conclude that the set is not a business because the set does not have the ability to create outputs through commercialization of the product, given the low likelihood of approval. If the Board believes that this set, as described in the Proposal, has the ability to create outputs, we recommend that the Board explain how it is deemed to have that ability.

In addition, ASC 805-10-55-4(b) indicates that “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.” Because this paragraph indicates that an organized workforce could be a process, we believe that an organized workforce could, by itself, represent a substantive process. The Board may want to clarify in proposed paragraphs 805-10-55-5A and 805-10-55-5B(a) that an organized workforce could *provide* or perform an acquired process.

Finally, we recommend that the Board remove the reference in proposed paragraph 805-10-55-5C of customer lists as an example of a contractual arrangement that provides for the continuation of revenues because we do not believe customer lists represent a contractual arrangement.

Question 3: Would the proposed guidance be operable without the criteria in paragraphs 805-10-55-5A through 55-5D? Why or why not?

As stated in our response to Question 2, we believe that including the proposed criteria is important to the operability of the Proposal. Therefore, we support adding the proposed criteria to determine whether a set contains an input and a substantive process. We believe that these criteria would promote consistent application of the definition of a business and improve our ability to audit an entity's conclusions of whether a process is substantive. However, please refer to our recommendations in our response to Question 2.

Question 4: Paragraph 805-10-55-9 provides that the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive. Do you think this indicator is appropriate and operable? Why or why not?

We agree that the presence of more than an insignificant amount of goodwill may indicate that a set includes a substantive process, and that the evaluation of this indicator is operable in practice. We agree that, without a change to this paragraph, the existing presumption that the presence of goodwill indicates a set is a business could contradict the guidance in proposed paragraphs 805-10-55-9A through 55-9C, which states that if substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not a business.

Question 5: Do you agree with the changes proposed to the definition of outputs? That is, do you agree that for purposes of evaluating whether a transferred set is a business, outputs should be focused on goods and services provided to customers? If not, why?

We support the proposed change to the definition of outputs. We agree with the Board that the current definition of outputs does not appropriately distinguish between an asset and a business, because many asset acquisitions can provide a return in the form of lower costs or other economic benefits and, therefore, would appear to have the ability to create outputs.

Question 6: Paragraphs 805-10-55-9A through 55-9C specify that if substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset, the set is not a business. Is it appropriate to include such a threshold, and would it be operable? If not, why?

We generally agree that adding the threshold would provide a practical approach to determining when certain sets do not constitute a business and that it would be operable. We believe that if substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset, in some cases, the accounting result may not differ materially if the transaction is accounted for as a business combination or an asset acquisition. However, since the models are not aligned, there will be differences, and those differences may be material depending on the facts and circumstances. As previously discussed, we encourage the Board to reduce or eliminate differences in the accounting for business combinations and asset acquisitions when it addresses those differences in a later phase of the project.

Composition of 'gross assets acquired'

The proposed paragraph 805-10-55-9A defines the denominator in the evaluation of the threshold as "gross assets acquired." To ensure that the threshold is applied consistently, we suggest the Board clarify that gross assets acquired includes any amount in excess of the identifiable net assets acquired (e.g., goodwill in a business combination).

Unit of account for the threshold evaluation

Proposed paragraph 805-10-55-9B says that, "a single identifiable asset includes any individual asset or group of assets that could be recognized and measured as a single identifiable asset in a business combination unless that group of assets cannot be combined under paragraph 805-10-55-9C." We recommend that the Board remove the words "unless that group of assets cannot be combined under paragraph 805-10-55-9C" because we believe the overarching principle for identifying a single asset should be whether that asset could be recognized as a single identifiable asset in a business combination. If these words remain, we believe entities would be required to evaluate whether components of a single identifiable asset should be separated, which would introduce additional complexity and possibly subject an entity to additional valuations solely for purposes of applying the threshold.

For example, the guidance in ASC 805-20-55-2(b) permits, but does not require, an acquirer of a power plant to recognize the fair value of the power plant (a tangible asset) and the license to operate the power plant (an intangible asset) as a single asset if the useful lives of those assets are similar. We believe that these two assets should be considered a single identifiable asset for purposes of applying the threshold as they could be recognized as a single identifiable asset in a business combination. Therefore, we also recommend that the Board clarify in proposed paragraph BC40 that the license and the power plant could be considered a single identifiable asset.

Classification of use right asset

We recommend that the Board clarify whether use rights are intangible or tangible assets for purposes of applying the threshold. ASC 805-20-55-37 describes use rights as generally intangible assets but says that some of these rights may have characteristics of tangible assets (e.g., mineral rights) and that these rights should be accounted for based on their nature. If a use right asset is an intangible asset, the proposed prohibition on combining intangible assets with related tangible property may limit the application of the threshold in certain common transactions. For example, an acquirer of a building commonly also acquires a ground lease on the land (i.e., the acquirer owns the building but leases the land). Although the land and building are attached and could not be used separately without incurring significant cost or significantly diminishing the utility or fair value of either asset, we do not believe that they could be combined using the guidance in the Proposal if the use right asset is an intangible asset. A similar situation may arise when evaluating whether an acquisition of a pipeline and the easements required to operate the pipeline meets the threshold.

Classification of mineral assets

In Case J, proposed paragraph 805-10-55-87 describes mineral interests as intangible assets but ASC 932-360-05-1 describes mineral interests as components of property, plant and equipment (i.e., tangible assets) in the oil and gas industry. Furthermore, mineral rights are referred to as tangible assets in ASC 805-20-55-37. We recommend that the Board modify this example to state that the mineral interests are tangible assets. This would require an assessment of whether the mineral rights should be combined with the other identifiable tangible assets (e.g., equipment, gathering system) for purposes of evaluating the threshold.

Order of analysis

Finally, we recommend that the Board change the order of the paragraphs in the Proposal so that they follow the required steps in the evaluation of whether a set is a business. In the Proposal, the guidance on whether a process is substantive precedes the guidance on the “substantially all” threshold. This may be an unnecessary source of confusion because the evaluation of whether substantially all the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets is the required first step in the analysis of whether a set is a business.

Question 7: The threshold in paragraph 805-10-55-9A also applies to a group of similar identifiable assets. Would the identification of a group of similar identifiable assets be operable? If not, why?

In many cases, we believe the guidance on identifying a group of similar identifiable assets would be operable, and we could make a reasonable determination of when assets are similar. However, we believe that, in some cases, diversity in practice could develop. Some may conclude that assets in the same major asset class are similar, even though the individual assets may have different risk characteristics, economic characteristics or other characteristics. For example, some may conclude that several in-process research and development (IPR&D) projects could be combined because they are intangible assets in the same major intangible asset class. This view would be supported by the guidance in proposed paragraph 805-10-55-9C, which indicates that intangible assets in different major intangible asset classes may not be combined, suggesting that assets within the same major intangible asset class could be considered similar. Others may consider the guidance in the AICPA Accounting and Valuation Guide, *Assets Acquired to Be Used in Research and Development Activities*, and conclude that the same IPR&D projects are not similar if, for example, they involve different therapeutic areas, compounds in different stages of development or different stages of approval in different geographic areas that make them separate units of account for purposes of impairment testing.

As another example, some oil and gas entities may conclude that proved and unproved properties are similar because both types of properties are comprised of mineral interests and are in the same major asset class. However, other oil and gas entities may conclude that they are not similar because they have different risks and impairment models.

We believe it would be helpful if the guidance stated whether tangible or intangible assets within the same major asset class would be considered similar for purposes of this analysis or whether an entity should further evaluate the nature, risks and characteristics of assets within the same major asset class to determine whether they are similar. If the Board believes that grouping assets within the same major

asset class (e.g., intangible IPR&D assets) would result in the threshold being applied too broadly, it should consider providing additional guidance to illustrate when such items would be similar.

Question 10: Do you agree that the amendments in this proposed Update should be applied prospectively to any transaction that occurs on or after the date of adoption, and do you agree that there should be no explicit transition disclosure requirements? Why or why not?

We agree that the proposed guidance should be applied prospectively to any transaction that occurs on or after the date of adoption. Prospective application would be consistent with other business combination-related standards and would be practical and cost effective.

We also agree that no disclosures are necessary for the effects of the Proposal on future transactions.

Question 11: Do the examples in paragraphs 805-10-55-51 through 55-88 clearly illustrate the application of the proposed guidance? Why or why not?

We generally agree that the examples in the Proposal clearly illustrate the application of the proposed guidance. However, we have suggestions about how to improve the following examples:

- ▶ Case E – Please refer to our response to Question 2, which highlights the evaluation of whether the set in this example has the ability to create outputs.
- ▶ Case F – Please refer to our response to Question 1, which highlights the importance of evaluating the guidance on determining whether a transaction is part of a business combination or should be accounted for separately.
- ▶ Case J – Please refer to our response to Question 6, which highlights the need for clarification in this example of whether mineral interests are tangible assets.

Question 12: Do the changes to the Master Glossary create any unintended consequences?

We believe that the proposed changes to the Master Glossary to eliminate the definition and refer to the implementation guidance are appropriate and reduce the risk of an entity not considering the implementation guidance that would be necessary to appropriately evaluate whether a set is a business.

However, we recommend removing proposed paragraph 805-10-55-3A, which repeats today's definition, because it may cause unnecessary confusion based on the proposed changes to the definition of a business, and in particular, the definition of outputs in proposed paragraph 805-10-55-4(c). For example, proposed paragraph 805-10-55-3A states that, "a business...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." The proposed paragraph 805-10-55-4(c) states that, outputs are "goods or services to customers, other revenues, or investment income, such as dividends or interest" and was amended to eliminate references to dividends, lower costs or other economic benefits.