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Proposed Accounting Standards Update: Business Combinations (Topic 805) *Clarifying the Definition of a Business*

The Accounting Principles and Assurance Services Committee (the "Committee") of the California Society of Certified Public Accountants ("CalCPA") respectfully submits its comments on the referenced proposals. The Committee is the senior technical committee of CalCPA. CalCPA has approximately 43,000 members. The Committee consists of 57 members, of whom 43 percent are from local or regional CPA firms, 30 percent are from large multi-office CPA firms, 13 percent are sole practitioners in public practice, 9 percent are in academia and 5 percent are in international CPA firms. Members of the Committee are with CPA firms serving a large number of public and nonpublic business entities, as well as many non-business entities such as not-for-profits, pension plans and governmental organizations.

The Committee agrees that it is worthwhile to clarify the definition of a business in ASC Topic 805. While the Committee believes that the proposals are helpful, we also believe that there will still be questions that will require judgment in practice.

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?

The Committee agrees with the basic requirements as stated in paragraph 805-10-55-3A. However, there are several issues that arise in the ensuing paragraphs:

- Is the actual presence of an output required? Wording is inconsistent. Per the definition in paragraph 805-10-55-3A, it is not; only the ability to create outputs is required (paragraph 805-10-55-4). But the first sentence of paragraphs 805-10-55-5 seems to require the presence of outputs when it would require that inputs and processes "are or will be used to create outputs." It might be better stated to require inputs and processes that "may be used to create outputs." This is an important distinction which should be clarified. We believe the presence of outputs should not be required as long as there is the ability to create outputs.
- The "process" has an over-dependence on an organized workforce. This runs through paragraphs 805-10-55-5A, 5B and 5D. This goes beyond the requirements of the principle stated in the definition in paragraph 805-10-55-4 b. The presence of a process should be evaluated following the basic principle in the first sentence of paragraph 805-10-55-4. The presence of an organized workforce is just one indicator

of the presence of a process. It is important, particularly if there are no outputs, but it should not be stated as an absolute requirement. Further, in the "virtual" world in which we live where many functions are outsourced, it is important to look at what is being done, not necessarily how it is being done.

- The provision in paragraph 805-10-55-9A that if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not considered a business may not be operable in all cases. See our response to Question 6.
- We are also providing other recommended wording changes to clarify text and eliminate inconsistent language. See Attachment A for further details.

The Committee believes that the subject of a transaction should be defined the same way as a business or as an asset by both the seller and buyer, and it would be useful to state this in the final standard. It would seem that both seller and buyer should be able to reach the same conclusion as to whether it is a business or an asset, as the input, process and output are the subject of the transaction and should not be affected by how either the seller or the buyer utilize the input, process or output. Each party to the transaction should be able to make this evaluation based on the facts.

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?

Subject to the matters discussed in our response to Question 1, the guidance in paragraphs 805-10-55-5A through 55-5D is helpful, but not essential. The paragraphs appear to explain and exemplify the basic principle in paragraph 805-10-55-5. However, they are stated simplistically and sometimes ambiguously. The Committee believes this guidance would be better presented as examples with their meaning more fully explained.

Further, they are presented as a "framework to assist an entity in evaluating whether the set includes both an input and a substantive process." This at a minimum implies that the content of those paragraphs is intended to be all-inclusive; the Board should remove any implication that they are all inclusive, and presenting them as examples would help in this regard.

While the guidance does seem to be operable in practice, the content is not all-inclusive and not conclusive in all situations.

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

Yes, the proposed guidance would be operable without paragraphs 805-10-55-5A through 55-5D. As stated in our response to Question 2, they are useful as examples and should be presented as such, but not as part of the basic standard.

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?

Yes, the Committee believes the presence of more than an insignificant amount of goodwill is an appropriate indicator that an acquired process is substantive. Goodwill is generally created by a business, so its presence is a useful indicator. However, wording of this paragraph should be modified to clarify the presence of excess consideration transferred over the fair value of net assets acquired may not be a conclusive indicator that an acquired process is substantive.

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?

The Committee believes that the definition requires clarification. See the first “bullet” of our response to Question 1. It should not be focused only on goods and services provided to customers, but should also embrace returns to owners.

Paragraph 805-10-55-3A refers to "providing a return in the form of dividends, lower costs, or other economic benefits directly to investors nor other owners, members or participants." These are the very words that are deleted from paragraph 805-10-55-4 c.; the words should be restored. For example, an entity may acquire a complete business to achieve ownership of its processes with no intention of using the acquired business directly in providing goods or services to customers. The processes may be very valuable, for example, to production activities. It would be helpful to clarify that the buyer's intention of ultimate use is not relevant to the determination of whether the set acquired constitutes a business or an asset.

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?

The Committee believes this threshold may not be operable in all cases, and recommends that it be restated as an indicator that the set may not be a business. It is a useful factor in indicating that the assets acquired may not be a business, but it should not be conclusive. For example, if a business is in financial distress, the fair value of its assets may be concentrated in one asset, with little value attributed to its other assets, which may be inputs, processes or outputs. But those other assets would exist and be important to it functioning as a business, regardless of what the acquiring entity intends to do with the acquired entity. The existence of a set should be viewed independently of value of its separate elements.

The Committee recommends that paragraph 805-10-55-9A be restated as follows:

805-10-55-9A Notwithstanding the guidance in paragraphs 805-10-55-4 through 55-9, if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, and there are no other significant assets or activities that indicate there is an integrated set of activities and assets, the set is not considered a business.

This is not the "bright line" which the Board may prefer, but the Committee believes that the bright line may not be operable.

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?

The Committee does not see any significant difficulty with the operability of this requirement.

Question 8: Will the proposed guidance reduce the cost and complexity of applying the definition of a business? Why or why not?

The Committee believes that the proposed guidance may reduce the cost and complexity of applying the definition of a business, but cannot say whether the reduction would be significant. The difficulties with the current definition are generally at the margin between what is an asset and what is a business; the line is moved by the proposed definition, but there will still be a margin where the definition will be difficult to apply. But the margin may be encountered less frequently.

Question 9: How much time would be necessary to adopt the amendments in this proposed Update? Should early adoption be permitted? Would the amount of time needed to apply the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities?

The time to implement the proposed amendments should not be any greater than under the existing requirements, and may be less. Early adoption should not be permitted; to do so would create inconsistencies among entities' accounting for a period of time with little benefit.

There should be no difference in the amount of time need to apply the proposed amendments by entities other than public business entities as compared with that needed by public business entities.

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?

The Committee agrees with the proposed transition provisions. There should be no explicit disclosure requirements.

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?

The Committee finds the examples to be generally helpful, with the following exception:

- Case B: See our response to Question 6. This example points out the critical flaw in paragraph 508-10-55-9A. The selling entity has the substantive processes in place and is making them available to the buyer through contractual relationships, so the set

acquired is a business and should be accounted for as such. That certain of the assets do not have any significant fair value does not mean that they do not exist.

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

The Committee does not believe the change to the Master Glossary, *per se*, creates any unintended consequences. But we do have concern with the definition, as explained in our responses to Questions 1 through 7.

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We thank you for the opportunity to comment on this matter. We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Sincerely,

A handwritten signature in black ink that reads "A.J. Major III". The signature is written in a cursive style with a large initial "A" and a bracketed "J".

A.J. Major III
Chair
Accounting Principles and Assurance Services Committee
California Society of Certified Public Accountants

ATTACHMENT A

REFERENCE:	EXPOSURE DRAFT READS:	FOR CONSIDERATION:	COMMENT
Glossary Definition	Paragraphs 805-10-55-3A through 55-6 and 805-10-55-8 through 55-9C define what is considered a business.	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 pParagraphs 805-10-55-4 through 55-6 and 805-10-55-8 through 55-9C define what is considered a business.	Consider making the proposed 805-10-55-3A the definition. This would make for a more meaningful glossary and online link.
805-10-55-4	A {remove glossary link} business {remove glossary link} consists of inputs and processes applied to those inputs that have the ability to create outputs.	A {remove glossary link} business {remove glossary link} usually consists of inputs and processes applied to those inputs that have the ability to create outputs.	Given that a business must include at least one input and one substantive process under the proposed guidance, consider inserting the word “usually” to address the plural use of “inputs” and “processes” here. Conversely, consider amending the use of plural verbiage.
805-10-55-4 b.	Accounting, billing, payroll, and other administrative systems typically are not processes used to create outputs. ...	Internal use a Accounting, billing, payroll, and other administrative systems typically are not processes used to create outputs....	While the “other administrative systems” language is indirectly responsive to this issue, consider clarifying that such systems, to the extent they are used in generating outputs (e.g., providing services to customers) may constitute relevant processes.

REFERENCE:	EXPOSURE DRAFT READS:	FOR CONSIDERATION:	COMMENT
805-10-55-4 c.	Output. The result of inputs and processes applied to those inputs that provide goods or services to customers, other revenues, or investment income, such as dividends or interest.	Output. The result of an input or inputs and a substantive process (or group of processes) applied to those that input or inputs that provide goods or services to customers, other revenues, lower costs , or investment income, such as dividends or interest, or other economic benefits directly to investors or other owners, members, or participants.	Consider adjusting the plural verbiage that suggests a need for multiple inputs and processes. Include other elements from paragraph 805-10-55-3A within the definition of an output.
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, which together are or will be used to create outputs. A business need not include all of the inputs or processes that the seller used in operating that business. However ...	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, which together are or will be used to create outputs. A business need not include all of the inputs or processes that the seller used in operating that business. However ...	As noted by the Committee in our letter (response to Question 1), the first sentence appears inconsistent with the preceding paragraph and subsequent sentences. It also appears redundant to the subsequent proposed sentences. Accordingly, consider removing the first sentence. Conversely, it might be better stated to require an input or inputs and process (or group of processes) that " <u>may</u> be used to create outputs." As written, the "are or will be" wording does not require that the seller actually be using the inputs and processes to create outputs, but it would require that the buyer do so. This would go beyond the definitional requirements; the definition of a business should be met even if the buyer has no intent to use the process acquired.

REFERENCE:	EXPOSURE DRAFT READS:	FOR CONSIDERATION:	COMMENT
805-10-55-5	However, to be considered a business, the set must include, at a minimum, an input and a substantive process that together contribute to the ability to create outputs.	However, to be considered a business, the set must include, at a minimum, an input and a substantive process that together contribute to the ability to create an output or outputs .	To adjust plural verbiage suggesting need for ability to create multiple outputs.
805-10-55-5A	When a set does not have outputs (for example, an early stage company that has not generated revenues), the set would have both an input and a substantive process that together contribute to the ability to create outputs if it includes an organized workforce that has 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. ...	When a set does not have an output or outputs (for example, an early stage company that has not provided goods or services to customers generated revenues), the set would, at a minimum , have both an input and a substantive process that together contribute to the ability to create an output or outputs if it includes such as an organized workforce that has 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 an output or outputs	<p>Please refer to the Committee’s concerns as to the requirement that “an organized workforce” must be included in the absence of output(s) to be considered a business. While the Committee understands that, absent such a rule, judgmental differences of what constitutes a business may occur, we believe a principles based model consistent with the language in 805-10-55-4 should be paramount. This issue is particularly relevant when in 805-10-55-5D, the proposed language asserts that contractual arrangements may take the place of “employees” in determining whether an assembled workforce exists.</p> <p>The use of added examples may minimize judgmental differences.</p> <p>At a minimum, adjust the plural verbiage suggesting need for ability to create multiple outputs. The language edits also clarify the minimum criteria and better align with the proposed definition of an output.</p>