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January 22, 2016
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

RE: Exposure Draft, *Clarifying the Definition of a Business* (File Reference No. 2015-330)

Dear Technical Director:

We appreciate the opportunity to comment on the proposed ASU, *Clarifying the Definition of a Business.*

We agree with the Board's objective of providing for greater consistency in applying the definition of a business, while at the same time reducing the cost and complexity of analyzing a set under the definition. However, we believe that certain aspects of the proposals should be modified in order to achieve the Board's objectives. Further, we believe that the examples should be expanded in order to help practitioners operationalize the guidance in a consistent manner.

KPMG's responses to the Board's specific questions and our other observations on the proposals are included in Appendix 1. This cover letter summarizes our key points.

Contracts that derive their value from a particular asset

In applying the threshold test in paragraph 805-10-55-9A, we believe that contracts that derive their value from a particular asset should be grouped with that asset. An example is in-place lease intangibles, including an intangible asset or liability arising from favorable or unfavorable lease contract terms, which derive their value from the related leased asset(s).

Historically, the definition of a business has been particularly difficult to apply in the real estate industry, and real estate transactions are likely to be the primary beneficiary of the Board's proposals. Our suggested simplification would result in more commercial real estate transactions meeting the threshold test that would likely qualify as asset transactions under the revised definition anyway. By meeting the threshold test, the additional work to evaluate the revised definition would not be necessary, thereby lowering the cost of making a determination. In our experience, the fair value of the lease-related intangible assets in a commercial real estate transaction often is not an insignificant portion of the transaction price. In applying the proposals as drafted, those transactions would fail the threshold test. This simplification would also directionally align practice under U.S. GAAP with IFRS.

Grouping and Related Examples

We believe that the proposed guidance on grouping could be interpreted too broadly. To help avoid this, we recommend adding “Identifiable assets with significantly different risk characteristics” as an additional factor in paragraph 805-10-55-9C.

In addition, we recommend expanding the examples to better illustrate the grouping of assets; currently only one example illustrates grouping. Notwithstanding our recommendation to add an additional factor, we believe that this area of the guidance (grouping) will involve significant judgment in some cases. Our response to Question 11 includes a suggested modification to the biotech example and two new examples (hotel and financial services).

Convergence with IFRS

We understand that the IASB will soon publish an exposure draft on the definition of a business that is based on the Board’s proposals. We recommend that the Boards jointly deliberate the comment letters on both sets of proposals. Notwithstanding that different interpretations may have emerged in practice, this is an area of current convergence between U.S. GAAP and IFRS. Redeliberating the comments together would be consistent with the Board’s stated intent of more closely aligning practice in this area.

* * * * *

We look forward to working with the Board as it continues to finalize the phases of its project on the definition of a business. If you have questions about our comments or wish to discuss the matters addressed in this comment letter, please contact Kimber Bascom at (212) 909-5664 or kbascom@kpmg.com, or Dan Langlois at (212) 872-3256 or dlanglois@kpmg.com.

Sincerely

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Appendix 1 – Responses to the Board's Questions

Question 1 – Minimum components

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?

Yes, we agree that a business must include, at a minimum, an input and a substantive process that together contribute to the ability to create outputs.

Question 2 – Guidance on minimum components

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?

Yes, we believe that the criteria in paragraphs 805-10-55-5A – 55-5D are appropriate and generally would be operable in practice.

As a drafting comment, we recommend that paragraph 805-10-55-5 refer to the guidance in paragraphs 805-10-55-5A – 55-5D as "criteria" instead of "a framework to assist an entity." We believe that this more accurately reflects the nature of the guidance, and is consistent with the reference in paragraph 805-10-55-9.

Question 3 – Necessity of guidance on minimum components

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

No, we do not believe that the guidance would be operable in a sufficiently consistent manner without the guidance in 805-10-55-5A – 55-5D. The lack of guidance in U.S. GAAP about processes has contributed to this being a difficult area to apply, and therefore we welcome guidance that would facilitate consistent application of the literature.

Question 4 – Goodwill as an indicator

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, we believe that the standard should state that the presence of goodwill might indicate a substantive process; we think that this is appropriate and operable.

However, as a drafting comment, we believe that the first sentence of paragraph 805-10-55-9 would be clearer if it more closely aligned with the wording used in paragraphs BC32 – BC33. In addition, we think that the context of this additional guidance about the presence of goodwill would be improved by placing it after paragraph 805-10-55-9C.

Question 5 – Definition of outputs

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?

Yes, we agree with the changes proposed to the definition of outputs; we agree that outputs should focus on goods and services provided to customers.

Question 6 – Threshold test

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?

Yes, we agree with including a threshold test. For acquisitions, we believe that this is a practical way of reducing the cost and complexity of analyzing whether the definition of a business is met. Requiring the threshold test to be applied in all cases will enhance comparability.

As drafting comments, we recommend:
- Moving the threshold test to before the guidance on whether a set contains an input and a substantive process. This means that the standard would be in the same order an entity would follow in working through the process of determining whether a set is a business or a group of assets.
- Clarifying in paragraph 805-10-55-9A that, for the purpose of applying the threshold test, the total amount of gross assets acquired includes goodwill. This is implicit in Case E with the acquired workforce, but we believe that the point should be made more explicit.

Question 7 – Grouping similar assets

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?

We agree with the principle of identifying a group of similar identifiable assets. However, in applying the threshold test in paragraph 805-10-55-9A, we believe that contracts that derive their value from a particular asset should be grouped with that asset. In such cases, we believe that it is appropriate to think of the asset and the related intangible(s) as a group for purposes of evaluating whether the set represents a business. An example is in-place lease intangibles, including an intangible asset or liability arising from favorable or unfavorable lease contract terms, which derive their value from the related leased asset(s). This would require a revision to paragraph 805-10-55-9C(a).

Historically, the definition of a business has been particularly difficult to apply in the real estate industry, and real estate transactions are likely to be the primary beneficiary of the Board's proposals. Our suggested simplification would result in more commercial real estate transactions meeting the threshold test that would likely qualify as asset transactions under the revised guidance anyway. By meeting the threshold test, the additional work to evaluate the revised definition would not be necessary, thereby lowering the cost of making a determination. In our experience, the fair value of the lease-related intangible assets in a commercial real estate transaction often is not an insignificant portion of the transaction price. In applying the proposals as drafted, those transactions would fail the threshold test.

This simplification would also allow the Board to directionally align practice under U.S. GAAP with IFRS. The IASB confirmed in December 2015 that, in applying IFRS 3, *Business Combinations*, the value of in-place leases is included in the fair value of the underlying leased asset.

Further, we believe that the proposed guidance on grouping in paragraphs 805-10-55-9B – 55-9C could be interpreted too broadly (i.e., resulting in assets being inappropriately grouped). To help avoid this, we recommend adding "Identifiable assets with significantly different risk characteristics" as an additional factor in paragraph 805-10-55-9C. We think that this new condition would encompass consideration of an asset's revenue-generating attributes.

In addition, notwithstanding our recommendation to add an additional factor, we do not believe that the guidance is operable without expanding the examples to better illustrate grouping (see our response to Question 11).

Question 8 – Reducing cost and complexity

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

Yes, we agree that the proposed guidance will reduce the cost and complexity of analyzing whether the definition of a business is met. However, our response to Question 7 recommends that contracts that derive their value from a particular asset be grouped with that asset in applying the threshold test, which will further reduce cost and complexity.

Question 9 – Time to adopt

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?

We believe that preparers are best placed to comment on the time that would be necessary to adopt the amendments, taking into account possible implications on the unit of account for impairment testing. However, we believe that early adoption should be allowed.

Question 10 – Prospective application

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?

Yes, we agree that the ASU should be applied prospectively to any transaction that occurs on or after the date of adoption. If the ASU is intended to reduce the cost and complexity of analyzing whether the definition of a business is met, we believe that retrospective application would be too burdensome for preparers.

Yes, we agree that there should be no explicit transition disclosure requirements. The ASU is transaction-based with no change in an entity's underlying accounting policy for previous acquisitions or disposals of a business versus a group of assets.

Question 11 – Examples

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

No, we believe that the examples in paragraphs 805-10-55-51 – 55-88 need clarification to fully illustrate the application of the proposed guidance. Currently only Case A (acquisition of single-family homes) illustrates grouping, which we believe is insufficient. We recommend modifying Case B (drug candidate) and adding two new examples (hotel and financial services).

Modifying Case B: Acquisition of a Drug Candidate

We recommend the following modifications to Case B (in black-line):

805-10-55-56 Pharma Co. purchases from Biotech a legal entity that contains the rights to a Phase 3 compound being developed to treat diabetes and a cancer drug treatment compound (both~~the~~ in-process research and development projects). Included in the in-process research and development projects are~~is~~ the historical know-how, formula protocols, designs, and procedures expected to be needed to complete the related phase of testing for each project. The in-process research and development projects have significantly different risk characteristics. The legal entity also holds an at-market clinical research organization contract and an at-market clinical manufacturing organization contract. The clinical research organization contract provides services in which the vendor performs certain research and development activities that are part of the current phase of the research and development activities required by the U.S. Food and Drug Administration. The clinical manufacturing organization contract provides access to some of the necessary materials to perform those activities. No employees, other assets, or other activities are transferred.

805-10-55-57 Pharma Co. first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. Based on the guidance in paragraph 805-10-55-9C, Pharma Co. concludes that the two in-process research and development projects should not be grouped as~~is~~ ~~an~~ single identifiable intangible asset because they have significantly different risk characteristics~~that would be accounted for as a single asset in a business combination~~. Pharma Co. also concludes that there is no fair value associated with the clinical research organization contract and the clinical manufacturing organization contract. ~~Therefore, all of the consideration in the transaction would be allocated to the in-process research and development project.~~ As such, ~~Big~~ Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a group of similar identifiable assets (the two~~single~~ in-process research and development assets) and that it must further evaluate whether the set has the minimum requirements to be considered~~the set is not~~ a business.

[New para] The set does not have outputs; therefore, Pharma Co. considers the criteria in paragraph 805-10-55-5A to determine whether the set includes both an input and a substantive process. Because the clinical research organization contract and the clinical manufacturing organization contracts provide some, but not all, of the necessary skills, knowledge and experience to develop the acquired inputs into outputs, Pharma Co. concludes that the set is not a business.

Based on our recommendation in Question 7, this modified example clarifies that the intangible assets acquired cannot have significantly different risk characteristics in order to group them for the threshold test. Under the proposals as currently drafted, Pharma Co. could determine that the two drug candidates should be grouped even though they have significantly different risk characteristics because they are in the same major class; as a result, the set would pass the threshold test. In addition, the example illustrates a situation in which no outputs exist and a contractual agreement takes the place of some, but not all, of a workforce.

New Example: Hotel REIT

XYZ REIT purchases a hotel and attached golf course, and the related fixed assets and inventory necessary for the hotel operations. The golf course is run as a separate business for paying members and guests, to which hotel guests have access. The hotel and golf course have significantly different risk characteristics. The elements of the acquired set include the hotel building, hotel land, golf course and related facilities, hotel furniture and fixtures, and hotel inventory. XYZ REIT plans to assume the management contract for the property and the hotel franchise agreement with a national hotel chain; these contracts are at market at the acquisition date.

XYZ REIT first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. In applying the guidance in paragraph 805-10-55-9B through 55-9C, XYZ REIT concludes as follows:

- The hotel building and fixtures are attached to the land and cannot be removed without incurring significant cost. Therefore, they are considered a single asset.
- The hotel building and fixtures are not grouped with the golf course because they have significantly different risk characteristics.
- The golf course facilities, furniture, and inventory are not grouped because they are considered separate major classes of tangible assets.

Next, XYZ REIT compares the fair value of the grouped assets (hotel, hotel land, and fixtures) with the fair value of the total gross assets acquired and concludes that the fair value is not concentrated in either the grouped assets or in any of the other classes of assets. As a result, XYZ REIT fails the threshold test and proceeds to the criteria in paragraph 805-10-55-5B.

XYZ REIT concludes that the criterion in paragraph 805-10-55-5B(a) is met because, through the operation of the management contract and applying the guidance in paragraph 805-10-55-5D, the set includes an organized workforce that performs processes critical to the ability to continue producing outputs when applied to the acquired inputs in the set. Because only one criterion in paragraph 805-10-55-5B needs to be satisfied, the set includes at least one input and at least one substantive process that together contribute to the ability to create outputs and is considered a business.

Although not relevant to forming a conclusion in this particular case, XYZ REIT considers the franchise agreement to be an acquired input because no services are performed through the contractual arrangement that are critical to the ability to create outputs when applied to another acquired input or inputs.

Based on our recommendation in Question 7, this example clarifies that the tangible assets acquired cannot have significantly different risk characteristics in order to group them in applying the threshold test. Under the proposals as currently drafted, XYZ REIT could determine that the golf course could be grouped with the hotel land and hotel building even though they have significantly different risk characteristics, which would likely result in the threshold test being passed.

New Example: Financial Services

CCM Bancorp acquires 100 percent of the shares in BB Bank. The elements of the acquired set include cash, CLO (collateralized loan obligation) securities, a CLO management contract (in which BB Bank is the customer) that is not at market, and loans. The cash, CLO securities, and loans have significantly different risk characteristics. CCM Bancorp plans to continue using the same third party to manage the CLO securities. CCM Bancorp will service the acquired loans with its own employees and management.

CCM Bancorp first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. In applying paragraphs 805-10-55-9B and 55-9C, CCM Bancorp concludes that it cannot group the cash, loans, and the CLO securities as similar assets because they are different major classes of financial assets that have significantly different risk characteristics. As such, CCM Bancorp concludes that the fair value of the gross assets is not concentrated in any of the financial assets or in the CLO management contract intangible asset. As a result, CCM Bancorp fails the threshold test and proceeds to the criteria in paragraph 805-10-55-5B.

CCM Bancorp concludes that the criterion in paragraph 805-10-55-5B(a) is met because, through the operation of the CLO management contract and applying the guidance in paragraph 805-10-55-5D, the set includes a contractual arrangement that takes the place of an organized workforce that performs processes critical to the ability to continue producing outputs when applied to the acquired CLO securities. Because only one criterion in paragraph 805-10-55-5B needs to be satisfied, the set includes at least one input and at least one substantive process that together contribute to the ability to create outputs and is considered a business.

Based on our recommendation in Question 7, this example clarifies that the financial assets acquired cannot have significantly different risk characteristics in order to group them in applying the threshold test. As currently drafted, CCM Bancorp could determine that the CLO securities and loans could be grouped even though they have significantly different risk characteristics, which would likely result in the threshold test being passed.

Question 12 – Master Glossary

Do the changes to the Master Glossary create any unintended consequences?

Yes, we believe that there is one significant unintended consequence resulting from the changes to the Master Glossary.

Suppose that an entity (seller) enters into a transaction to sell inputs only (because the buyer will apply its own processes to those inputs) and to separately exit the activities that make up the related processes. Because the definition of a business under the proposals focuses on what was *acquired*, in this example both the buyer *and* seller will conclude that the set is a group of assets. As a result, the seller will not write off a portion of the reporting unit's goodwill in measuring the gain or loss.

To avoid this outcome, we recommend amending paragraph 350-20-40-2 to apply when a business is disposed *and* when a business is exited through a combination of sale of some parts of a business (i.e., without the associated processes) along with exit activities for the related processes. Absent this amendment, issues related to the carrying amount of goodwill would be left to an impairment test. That would raise a question about whether an impairment test would be triggered immediately rather than waiting for the next annual test.

Other Matters – Private Companies and the Board's Project on Identifiable Intangible Assets

It is not clear that the Board has sufficiently considered the consequences of these proposals on ASU 2014-18, *Accounting for Identifiable Intangible Assets in a Business Combination (a consensus of the Private Company Council).*

We understand that the Board's intent is for goodwill to be included in the gross assets acquired (see drafting comment in our response to Question 6), which means that a private company applying the alternative in ASU 2014-18 will have more goodwill. This may have unintended consequences:

- In applying the threshold test, there will be no opportunity to group the intangible assets subsumed into goodwill because they are not identifiable, which means that it is less likely that substantially all of the fair value of the gross assets acquired will be concentrated in a group of similar identifiable assets.

- Depending on how the Board finalizes goodwill as a potential indicator of a business (Question 4), a higher amount of goodwill may indicate that a business has been acquired.

Although we believe that there is not a high risk that a private company will be disadvantaged, this raises a broader question about the interaction of this project with the Board's project on accounting for identifiable intangible assets in a business combination for public business entities and not-for-profit entities.

Convergence with IFRS

We understand that the IASB will soon publish an exposure draft on the definition of a business that is based on the Board's proposals. We recommend that the Boards jointly deliberate the comment letters on both sets of proposals. Notwithstanding that different interpretations may have emerged in practice, this is an area of current convergence between U.S. GAAP and IFRS. Redeliberating the comments together would be consistent with the Board's stated intent of more closely aligning practice in this area.