

Understanding a Business Combination Transaction versus an Asset Purchase Transaction

Kevin M. Zanni

Valuation analysts (“analysts”) who provide specialist services related to business combination financial accounting should be aware of certain basic processes and procedures. Such analysts need to review and understand recent professional guidance introduced by the Financial Accounting Standards Board (“FASB”). The FASB regularly issues updates and modifications to U.S. generally accepted accounting principles (“GAAP”). The FASB promulgates these GAAP changes through the issuance of Accounting Standards Updates (“ASUs”). These ASUs affect fair value measurements for financial accounting purposes. Certain ASUs are more significant than others with regard to fair value measurements. One of the more significant and recent ASUs is ASU 2017-01, which involves the definition of a transaction as either a business combination or an asset purchase. Analysts should be aware that there are important differences between the financial accounting treatment and fair value measurement of a business combination transaction versus that of an asset purchase transaction.

INTRODUCTION

The change to the fair value accounting and reporting of certain transactions represents a paradigm shift from historical-cost-based accounting to a more relevant and current measurement of accounting value. Fair value accounting is widely viewed as an improvement to the cost-based form of accounting.

Under historical-cost-based accounting, the initial price paid by the company during the purchase of the asset or incurrence of the liability is the most relevant pricing indication. The recorded value on a historical-cost-based balance sheet is either the original purchase price or a value reduced by obso-

lescence (considering functional, technical, and/or economic) depreciation or depletion.

Historical-cost-based accounting is easy to understand because it is based on a fixed price that is a known amount; specifically, the cost typically represents the actual price that a company paid. Historical-cost-based accounting is generally easier to follow since it is based on fixed and certain inputs.

To investors, fair value accounting provides a change to how financial information is viewed and consumed. The shift to fair value measurement provides the accounting basis of value for reporting both financial and nonfinancial assets and liabilities.

There are many relevant Financial Accounting Standards Board (“FASB”) Accounting Standard Codification (“ASC”) topics that require analysts to provide fair value measurements. Fair value measurement involves the process of determining the fair value of financial and nonfinancial assets and liabilities when fair value accounting is required or permitted.

Analysts are often engaged by reporting companies to develop fair value measurements of intangible assets, stock compensation, goodwill, and so forth.

Exhibit 1 presents a few of the FASB ASC topics for which analysts are often engaged to provide fair value measurement services during the course of the financial accounting.

As presented in Exhibit 1, there are numerous ASC topics that involve fair value measurements. The majority of ASC topics are based on guidance provided by ASC Topic 820, Fair Value Measurement.

ASC Topic 820 provides authoritative guidance for measuring fair value of assets liabilities and equity interests. For example, based on the ASC Topic 820 fair value guidance, analysts often prepare ASC Topic 805 business combination analyses and ASC Topic 350 intangible asset and goodwill impairment testing analyses.

The purposes of this discussion are twofold. First, this discussion summarizes the FASB guidance and the general process by which fair value guidance changes generally accepted accounting

principles (“GAAP”). Second, this discussion provides commentary about ASC Topic 805 business combinations, and, more specifically, considers recent changes to ASC Topic 805.

In the past few years, one of the most significant Accounting Standards Updates (“ASUs”) involving ASC Topic 805 relates to the definition of a business for the purposes of treating a business purchase as either:

1. a business combination or
2. an asset purchase.

The updated ASU guidance has made the treatment of a business purchase more restrictive as to how the purchase is recorded. There are several accounting treatment differences between:

1. a business combination purchase and
2. an asset purchase.

An analyst working on an ASC Topic 805 assignment should be aware of the differences between the financial accounting treatment (1) of a business combination purchase and (2) of an asset purchase.

FAIR VALUE MEASUREMENT GUIDANCE

In the United States, GAAP represent a common set of accounting principles. The GAAP standards and

Exhibit 1

FASB Accounting Standard Codification Topics That Involve Fair Value Measurements

ASC Topic 350, Intangibles—Goodwill and Other

ASC Topic 360, Property, Plant, and Equipment (specifically long-lived asset impairment)

ASC Topic 606, Revenue from Contracts with Customers

ASC Topic 715, Compensation—Retirement Benefits

ASC Topic 718, Compensation—Stock Compensation

ASC Topic 805, Business Combinations

ASC Topic 820, Fair Value Measurement

ASC Topic 825, Financial Instruments

ASC Topic 860, Transfer and Servicing

ASC Topic 946, Financial Services—Investment Companies

ASC Topic 965, Plan Accounting (This ASC Topic is relevant for actuaries as it relates to pensions; however, knowledge that this ASC Topic exists and its purpose may be important for valuation professionals.)



procedures are followed by companies for the reporting of financial information. GAAP is a set of standards (developed primarily by FASB) designed to improve transparency in financial statements.

The intent of GAAP is to promote and ensure a level of consistency in financial statements so that users may understand, analyze, and compare financial information.

Effective for periods ending after September 15, 2009, the FASB ASCs became the source of authoritative GAAP to be applied to nongovernmental entities. ASC Topic 105, established the Codification as the sole source of GAAP in the United States for nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (“SEC”) are also sources of authoritative GAAP for SEC registrants.

In other words, currently all other accounting literature is considered nonauthoritative.

In addition to the authoritative GAAP established in ASC Topic 105, nonauthoritative GAAP is also defined. Accounting and financial reporting practices which are not included in the Codification are considered to be nonauthoritative.

Nonauthoritative guidance includes ASUs, industry accounting practices, American Institute of Certified Public Accountants issue papers, and professional association or regulatory agency pronouncements.

For ASU guidance, each ASU explains how FASB has changed GAAP by amendment of the codifications. In isolation, an ASU is not authoritative; rather, the ASU communicates how the respective ASC is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective.

GAAP is based on FASB pronouncements and statements, SEC regulations for public companies, and accounting practices developed by industries and other recognized bodies over time.

The application and adherence to GAAP standards do not guarantee the financial statements will be free of errors, omissions, or misstatements.

FASB Board

The FASB facilitates change through the service of its seven full-time members (the “Board”). The FASB members are appointed for five-year terms. FASB members are eligible for an additional five-year term. Board member terms expire on June 30 at the end of their respective five-year term period.

The FASB standards-setting process for GAAP updates varies, but it generally follows the following procedures:¹

1. The FASB identifies financial accounting issues based on requests/recommendations from stakeholders or through other means.
2. The FASB decides whether to add a project to the technical agenda based on staff-prepared analysis of the issues.
3. The FASB deliberates at one or more public meetings the various reporting issues identified and analyzed by the staff.
4. The FASB issues an exposure draft to solicit broad stakeholder input.
5. The FASB holds a public roundtable meeting on the exposure draft.
6. The staff analyzes comment letters, public roundtable discussion, and all other information obtained through due process activities. The Board redeliberates the proposed provisions.
7. The FASB issues an ASU describing amendments to the relevant ASC.

To assist it in governing and setting policy, FASB has several advisory groups. According to the FASB website, the primary role of advisory group members is to share views and experiences with the FASB on matters related to projects on the Board’s agenda, possible new agenda items, practice and implementation of new standards, and strategic and other matters.

Information provided by advisory group members is communicated to the Board in a variety of ways, including public advisory meetings and comment letters.²

FASB advisory groups include the (1) financial accounting standards advisory council, (2) investor advisory committee, (3) not-for-profit advisory committee, and (4) small business advisory committee.

Other FASB groups include the Private Company Council and the Emerging Issues Task Force.

Overview of Business Combinations

In a business combination, it is the responsibility of company management to identify the tangible assets and intangible assets subject to the analysis. However, accountants provide an important role in the analysis and financial accounting of business combinations through purchase price allocations.

The first procedure in accounting for a business combination is recognizing and measuring the identifiable assets acquired, the liabilities assumed, the consideration transferred, and any noncontrolling interest in the acquired company. The accountants generally rely on independent analysts to measure the fair values of acquired assets and liabilities.

ASC Topic 805 provides guidance in each of these areas.

ASC Topic 805 provides U.S. GAAP guidance related to business combinations. ASC Topic 805 provides GAAP guidance related to the accounting for—and the reporting of—transactions that represent a business combination that should be recorded using the acquisition method of accounting.

The following list provides ASC Topic 805 subtopic categories:

1. 805-10 Overall
2. 805-20 Identifiable Assets and Liabilities, and Any Noncontrolling Interest
3. 805-30 Goodwill or Gain from Bargain Purchase, including Consideration Transferred
4. 805-40 Reverse Acquisitions
5. 805-50 Related Issues
6. 805-740 Income Taxes

Each subtopic includes multiple subsections. The subtopics are subject to ongoing FASB review and possible amendment.

The requirements for how the acquirer in a business combination accomplishes 805-10-05-01 include the following financial accounting objectives:

1. Recognizing and measuring (a) the identifiable intangible assets acquired, (b) the liabilities assumed, and (c) any noncontrolling interest in the acquiree entity
2. Recognizing and measuring either (a) the goodwill acquired in the business combination or (b) any gain from a bargain purchase in the business combination

3. Determining what information to disclose to allow its financial statement users to evaluate the nature of—and the financial effect of—the business combination

The acquisition method of accounting is described in ASC Topic 805-10-05-4. A business combination is defined in ASC Topic 805-10-20 as “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 are also business combinations.”

To comply with U.S. GAAP, the business combination buyer will record and measure:

1. tangible assets and liabilities that were acquired and
2. intangible assets that were acquired.

ASC TOPIC 805 INTANGIBLE ASSET CONSIDERATIONS

In an ASC Topic 805 assignment, the analysis of tangible assets is relatively straightforward. Typically, management can easily identify the tangible assets and there is likely a market value indication for the subject tangible asset.

Specialty property appraisers are sometimes used to provide a tangible asset fair value measurement for certain tangible assets. For example, a tangible property appraiser may be retained to provide the fair value measurement of pieces of large industrial machinery.

For intangible assets, the identification and analysis of intangible assets often requires judgment. That is, judgment is required from management to appropriately identify the subject intangible assets. Judgment is also required from the analyst during the fair value measurement of intangible assets.

For acquisition accounting purposes, an intangible asset is considered to be identifiable if it meets either of the following two ASC Topic 805-20-55-2 criteria:

- The intangible asset is separable, that is, capable of being separated or divided from the entity that holds it and sold, transferred,

“[A]ccountants provide an important role in the analysis and financial accounting of business combinations through purchase price allocations.”

licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the acquirer intends to do so.

- The intangible asset arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the acquiree or from other rights and obligations of the acquiree.

Assuming an identified asset meets the ASC Topic 805-20-55-2 criteria, there are five common types of intangible asset categories to consider in an ASC-Topic-805-type analysis.

The following list provides the ASC Topic 805-20-55-13 categories of identifiable intangible assets:

- Marketing-related intangible assets (for example: trademarks, service marks, trade names, and certification marks)
- Customer-related intangible assets (for example: customer lists, customer contracts and related customer relationships, order or production backlogs)
- Artistic intangible assets (for example: plays, operas, ballets, books, magazines, literary works, musical works, photographs, motion pictures, music videos, and television videos)
- Contract-related intangible assets (for example: license, royalty, standstill agreements, advertising contracts, lease agreements, construction permits, construction contracts, broadcast rights, franchise rights, operating rights, use rights, and employment contracts)
- Technology-related intangible assets (for example: patented or copyright software, mask works, unpatented technology, databases, trade secrets)

IS THE TRANSACTION A BUSINESS COMBINATION OR AN ASSET SALE?

Under ASC Topic 805, a business combination occurs when an entity obtains control of a “business.” The definition of a business under ASC Topic 805 is somewhat broad, which has resulted in many transactions qualifying as a business combination.

The determination of whether the acquired activities and assets constitute a business is important. This is because the accounting for a business

combination differs significantly from that of an asset acquisition.

Because significant judgments are required to conclude whether an acquired set of activities and assets is a business, companies should carefully evaluate their specific facts and circumstances when applying the guidance in ASC Topic 805.

To assist in the determination of either a business combination or an asset sale, FASB provided updated guidance through a January 2017 ASU. FASB issued ASU 2017-01 to provide certain clarity regarding how ASC Topic 805-10-55-4 defines a business.

This ASU update was issued in response to feedback from stakeholders that the definition of a business was applied too broadly, causing many transactions to be recorded as business combinations that may have been more appropriately classified as asset acquisitions.

The amendments provided by ASU 2017-01 resulted in the following changes to ASC Topic 805-10-55-4:

- Single or similar asset threshold (if *substantially all* of the fair value of the gross assets is concentrated in a single asset or group of similar assets, the set is not considered a business).
- To be considered a business, a set should include, at a minimum, an input and a process (both are required to significantly contribute to the ability to create an output).
- Elimination of the market participant determination regarding any missing elements of a business.
- Outputs are focused on revenue rather than the previous inclusion of “other economic benefits.”
- Based on the ASU 2017-01 guidance, the FASB maintains inputs, processes, and outputs as the main elements of a business. However, it removes considerations that complicated the prior definition and identifies new considerations that have seemingly less ambiguity.

The ASU 2017-01 guidance requires an entity to first evaluate whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. If that threshold is met, the set of assets and activities is not a business. If it is not met, the entity evaluates whether the set meets the definition of a business.

The updated definition requires a business to include at least one substantive process and narrows the definition of outputs by more closely aligning it with how outputs are described in the new revenue recognition guidance.

Under ASU 2017-01 guidance, the market participant exception was removed. In addition, updated guidance indicates that while not all inputs or processes that a seller uses to operate the business are necessary, the set should minimally include an input and a substantive process.

Together, the set input and process should significantly contribute to the ability to create output in order to be classified as a business.

Figure 1 provides a general flowchart on how to view the business purchase under the updated guidance.

Based on ASC Topic 805-10-55-5(a-e), there are many factors to consider in a business purchase—namely, whether the purchase is either:

1. a business combination or
2. an asset purchase.

As can be observed in Figure 1, the updated guidance provides that not all inputs or processes that a seller uses to operate the business are necessary. However, to be classified as a business, the set must minimally include an input and a substantive process that together significantly contributes to the ability to create output.

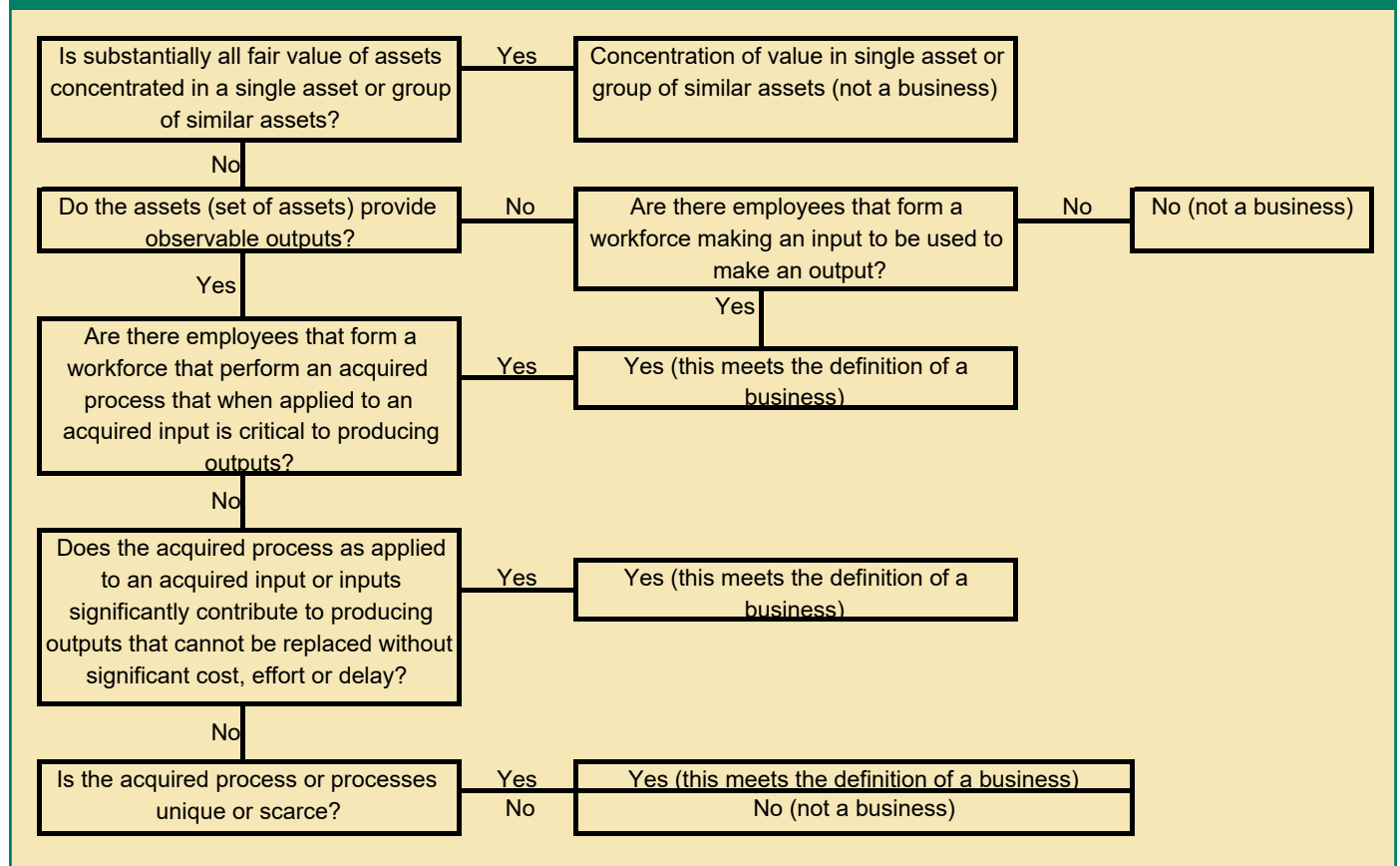
Also in ASU 2017-01, FASB changed the definition of output to be the result of inputs and processes to those inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenue.

Primary Differences between a Business Combination and an Asset Purchase

The updated definition of a business does not change the acquisition method of accounting for business combinations or the accounting for asset acquisitions outlined in ASC Topic 805-50.

However, given the narrower definition of a business outlined in ASU 2017-01, asset acquisitions

Figure 1
Flow Chart: Business Combination or Asset Purchase Considerations
Based on ASC Topic 805-10-5A-5E



have become more frequent, particularly in certain types of industries including life science, real estate, and asset management industries.

Based on the recognized accounting differences between the acquisition of an asset and the acquisition of a business, it may be preferable for an acquirer to desire one accounting treatment over the other.

Exhibit 2 presents a comparison (from an accounting perspective) of certain differences between the acquisition of a business and the acquisition of an asset.

As presented in Exhibit 2, there are many differences in the financial accounting treatment for (1) a business combination and (2) an asset acquisition.

One difference is the treatment of transaction costs—in a business combination the transaction costs are expensed as incurred whereas in an asset acquisition, the transaction costs are capitalized as a component of the acquired assets.

Other differences that are noteworthy involve the treatment of goodwill and the recognition of a bargain purchase.

To the extent that the purchase price plus the fair value of any noncontrolling interest in the acquiree exceeds the fair value of the tangible and intangible assets acquired, net of assumed liabilities, the excess price is recognized as goodwill (ASC Topic 805-30-30-1) in a business combination.

In an asset acquisition, goodwill is not recognized. Instead, the cost of the group of assets (i.e., the purchase price) is allocated to the individual assets acquired or liabilities assumed based on relative fair value (ASC Topic 805-50-30-3).

Because an assembled workforce is not an identifiable asset in business combinations, it is included into goodwill (ASC Topic 805-20-55-6). However, in an asset acquisition, intangible assets may meet the intangible asset recognition criteria in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, without meeting the contractual-legal criterion or the separability standard.

Because of the relatively less strict recognition criteria, an assembled workforce may be recognized as an intangible asset in asset acquisitions.

If the fair value of the net assets acquired and liabilities assumed exceeds the total purchase price of the transaction in a business combination, then

the resulting bargain purchase price gain will be recognized in earnings on the acquisition date, as discussed in ASC Topic 805-30-25-2.

For an asset acquisition, the bargain purchase price is allocated to the individual assets acquired or liabilities assumed based on relative fair value.

SUMMARY OF RECENT ASC TOPIC 805 GUIDANCE

FASB continues to refine fair value accounting as it (1) seeks feedback from stakeholders and (2) provides transparency and consistency in the reporting of financial statements.

The FASB follows seven general procedures to establish new guidance. This process can lead to new ASUs and further fair-value-related guidance.

ASU amendments affect the valuation considerations for both the entities involved and the consultants providing the necessary valuation services. It is important for analysts to be aware of GAAP and the ongoing ASUs in order to appropriately recognize, understand, and implement the potential impact on valuation engagements, including the potential scope of such assignments.

By now, analysts should be aware of ASU 2017-01 and its implications in determining what an entity has acquired in a business purchase. Determining whether an entity has acquired a business or an asset or a group of assets is important. That is because the fair value measurement procedures for a business combination differ significantly from procedures for an asset acquisition.

The new definition of a business in ASC Topic 805 has resulted in additional transactions being accounted for as an asset acquisition rather than as a business combinations. A transaction may be considered an asset acquisition under ASC Topic 805, and an acquisition of a business for purposes of SEC reporting.

Notes:

1. www.fasb.org, About Us/Standard-Setting Process.
2. www.fasb.org/facts

Kevin Zanni is a managing director of the firm and the director of the firm's Chicago office. Kevin can be reached at (773) 399-4333 or at kmzanni@willamette.com.

