PURCHASE OF ASSETS VS. PURCHASE OF A BUSINESS: WHAT'S THE BIG DIFFERENCE?

The lines between a business and a group of assets aren't always clear — but it's critical to know the distinctions. Here's how the right analysis can help you meet financial reporting requirements and keep accurate financial statements.

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In most acquisitions, the buyer generally knows whether a business or a group of assets has been purchased. However, for certain type of transactions, namely those involving development-stage companies from the life sciences, medical products, pharmaceutical, petroleum and software industries, the distinction isn't always clear. Why? Because the acquired assets aren't yet producing outputs.

In these and other transactions where the distinctions are blurred, the purchaser should be keenly interested in determining whether the group of assets qualifies as a business. Accounting and reporting are significantly different for the two types of transactions, and they'll impact current and future financial results; financial statement disclosures; and audit and consulting fees.

Back to basics: what's a business?

US GAAP and ASC 805, *Business Combinations*, defines a business as:

> *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.*

Put more simply, the guidance in ASC 805 specifies that: "a business consists of **inputs** and **processes applied to those inputs** that have the ability to create **outputs**." To qualify as a business, a set of activities or assets requires both inputs and processes applied to those inputs; outputs aren't necessary.

While a set of activities or assets might possess inputs and processes, the set would not necessarily qualify as a business if the integrated set can't create outputs. Consider the example of a start-up software company with a handful of employees, some equipment and a pending patent (inputs) and a standard protocol for writing and testing software (process). If the company lacks a key input or process necessary to be capable of producing outputs, and that missing element is not known to exist in the world of potential buyers, then the company would not qualify as a business. On the other hand, if a market participant could supply the missing input or process, then the set would qualify as a business.

When evaluating whether a set of activities or assets that lacks outputs qualifies as a business, the guidance in ASC 805 indicates:

> . . . the acquirer should consider other factors to determine whether the set is a business. Those factors include, but are not limited to, whether the set:
>
> a. Has started planned principal activities
>
> b. Has employees, intellectual property and other inputs and processes that could be applied to those inputs
>
> c. Is pursuing a plan to produce outputs
>
> d. Will be able to obtain access to customers that will purchase the outputs.

Lastly, when evaluating whether a group of activities or assets qualifies as a business, the analysis should disregard how the seller used the group and what the buyer intends to do with the group. Rather, the analysis should focus on how a market participant buyer would use the activities or assets in its operations.

What's the difference for accounting?

If the business qualifications aren't met, then the purchaser accounts for the transaction as an asset purchase and allocates the purchase price to individual assets based on their relative fair values. Here's an example.

	Fair Value	**Fair Value as Percent of Total Fair Value**	**Cost of Acquired Assets**	**Allocated Cost**
Current Assets	$200	17%		$250
Current Liabilities	-$100	-8%		-$125
Working Capital	$100	8%		$125
Equipment	$1,000	83%		$1,250
Patent	$100	8%		$125
Total	$1,200	100%	$1,500	$1,500

But when the acquisition qualifies as a purchase of a business, the acquirer accounts for the transaction as a business combination. In this case, the acquirer records the assets on its books at fair value (as define by ASC 820) regardless of the purchase price.

	Fair Value < Purchase Consideration	Fair Value > Purchase Consideration
Fair Value of Net Assets		
Current Assets	$200	$200
Current Liabilities	-$100	-$100
Working Capital	$100	$100
Equipment	$1,000	$1,000
Patent	$100	$100
Total Fair Value	$1,200	$1,200
Total Purchase Consideration	$1,500	
Total Fair Value of Net Assets	$1,200	
Goodwill	$300	
Total Fair Value of Net Assets		$1,200
Total Purchase Consideration		$1,000
Gain on Bargain Purchase		$200

On the surface, accounting for an asset purchase and a business combination seems fairly straightforward. For an asset purchase, allocate the purchase price to the acquired assets based on their relative fair values. For a business purchase, record the acquired assets at fair value regardless of the purchase price.

Actually, it's not that simple. The accounting and reporting differences between the two types of transactions are significant, and they'll affect current and future earnings, statement disclosures and audit and consulting fees.

Here are some of the major differences.

	Asset Purchase	Business Combination
Measurement of acquired assets and assumed liabilities	Measure at cost based on relative fair value	Measure at fair value regardless of price paid for business
Acquisition-related costs	Add to cost of acquired assets	Expense when incurred
Goodwill or gain from a bargain purchase	Do not recognize goodwill or a gain from a bargain purchase	Recognize goodwill or gain from a bargain purchase at the acquisition date
Deferred taxes	Do not recognize deferred taxes	Recognize deferred tax asset or liability at the acquisition date
Contingent consideration	Recognize when it is probable liability has been incurred and amount can be reasonably estimated	Recognize at fair value at the acquisition date
In-process research and development (IPR&D) assets	Expense value of IPR&D assets unless the assets have an alternative future use	Recognize IPR&D assets at their fair value at the acquisition date
Assembled workforce asset	Recognize as a separate asset	Do not recognize as a separate intangible asset; fair value of workforce asset is included in goodwill

Most accounting practitioners agree that accounting for a business combination is more complicated, burdensome and unfavorable than accounting for an asset purchase for myriad reasons.

In the accounting for a business combination, an acquirer must:

1) Expense transaction costs,
2) Recognize deferred taxes,
3) Recognize and value IPR&D assets, contingent consideration and goodwill (or gain from bargain purchase),
4) Generally, obtain independent appraisals of tangible and intangible assets as of the acquisition date,
5) Have appraisals reviewed by auditors and their valuation personal for compliance with accounting and valuation standards,
6) Address more disclosure requirements,
7) Test indefinite lived intangible assets and goodwill for impairment annually,
8) Monitor IPR&D assets to determine if they should be converted to finite lived assets or written-off and
9) Revalue contingent consideration in each reporting period.

Lastly, a business combination can lead to greater variability in reported earnings due to more periodic adjustments.

Regardless of the type of transaction, you must determine the fair value of the acquired assets. At AccuVal-LiquiTec, our experienced staff of business, intangible asset, inventory, and machinery and equipment appraisers can assist you in meeting your financial reporting requirements for the unique conditions before you.

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