L·B·B BRIEFS FOR SMALLER REPORTING COMPANIES

BUSINESS OR ASSET – YOU CAN'T ALWAYS RELY ON FIRST IMPRESSIONS

When it comes to deciding whether something is a business or a group of assets, you can't always rely on your instincts. Some acquired groups don't look like businesses in the traditional sense, but still meet the accounting definition. Some examples include certain types of outsourcing arrangements, licensing arrangements, and property acquisitions.

So, why does it matter?

For starters, the accounting for transaction costs, in-process research and development (IPR&D), excess purchase price (goodwill), and contingent consideration differs significantly depending on whether a business or a group of assets has been purchased. There are other implications as well, including the accounting for disposals. And, SEC rules require financial statements for acquired businesses—but not assets—that are significant.

Indicators that it's a "business"

Here's the official definition: a business is an integrated set of activities and assets that is capable of producing outputs and providing a return to investors. What does that mean? While this is not all encompassing, here is an overview as a point of reference:

Business versus asset: preliminary indicators

Business combination	Asset acquisition
• Key business process acquired	• No processes acquired or only administrative processes acquired
• A market participant could manage the assets to provide a return to its owners	• A market participant could not manage the assets to provide a return to its owners without combining them with other assets
• Key elements are missing but can be easily replicated	• Key elements are missing and cannot be easily replicated or obtained
• Key employees hired	• No employees hired
• Able to produce "Day 1" outputs	• Not able to create economic benefits
• Presence of goodwill	• No goodwill present

PERFORMANCE AWARDS—ARE YOU ON THE SAME PAGE?

Compensation committees have a lot to keep track of these days: say on pay, clawback requirements, and more. On top of all that, there's the age-old challenge of linking executives' pay to their performance. Here, flexibility is often desired to tailor performance goals to individuals. But when it comes to equity-based awards, performance metrics that lack sufficient objectivity can throw a wrench into the accounting treatment.

The key question: is there a "mutual understanding"?

One of the requirements for establishing a "grant date" for an equity-based performance award is that the company and employee have a mutual understanding of the key terms and conditions. Why is grant date important? It's the date that fair value becomes "fixed" for an equity award.

A mutual understanding is typically established through a written agreement that outlines the performance metrics that the employee needs to achieve. Performance metrics take a variety of forms, including financial metrics (for example, revenue or EPS targets), operating metrics, or specific actions of the company or employee.

To establish a grant date, performance metrics need to be clear and objectively determinable. Said another way, both parties need to understand how to measure whether the metric was achieved.

When performance metrics lack objectivity
Some performance metrics are not well-defined or lack objectivity. Some examples:

An award tied to an employee's performance evaluation, when the evaluation process is highly subjective

A metric that is defined upfront, but the compensation committee has the discretion to adjust the metric or even claw back the award—and it's not clear when or how that discretion will be used

These types of provisions require special attention and may indicate there's not yet a mutual understanding—or a grant date. If there's no grant date, the fair value (and expense to be recorded) is not fixed until the terms and conditions are known and the discretion is removed. This might not occur until the end of the service period. Until then, the award is typically subject to variable (that is, mark-to-market) accounting.