FOCAL POINT
DATA RISK

INSIGHTS INTO INTERNAL AUDIT PROCEDURES AROUND BUSINESS COMBINATIONS

Business combinations and asset acquisitions have always been highly scrutinized by management, boards of directors, and auditors, particularly in regards to the associated valuations and accounting treatment. It has become common practice to utilize and rely upon a third party to perform the valuation and give guidance regarding proper treatment.

However, in recent years, the PCAOB has given consistent feedback regarding the lack of sufficient audit evidence and procedures performed around such transactions. The Focal Point team has reviewed PCAOB inspection reports for the major accounting firms in the U.S., and summarized the Board's key observations around business combinations:

Management Review	• Procedures over the valuations of acquired assets, liabilities, and cash flow projections were not properly reviewed. • Calculation errors missed during management review that impacted financial statement disclosures.
Insufficient Testing	• Lack of sufficient testing over the valuation of acquired assets, goodwill, and/or intangible assets. • Management must have a complete understanding of all inputs and assumptions used by the third party and perform independent validations.
Material Omissions	• Departures from GAAP created potential material omissions from the business combination disclosures and were not properly depicted.
Limited/Lacking Controls Testing	• Failure to perform sufficient procedures to test the design and operating effectiveness of controls relating to business combination transactions leads to insufficient assessments over the control environment.
Improper Classification	• Acquired assets were not properly classified, impacting the valuation of and amortization on the financial statements.

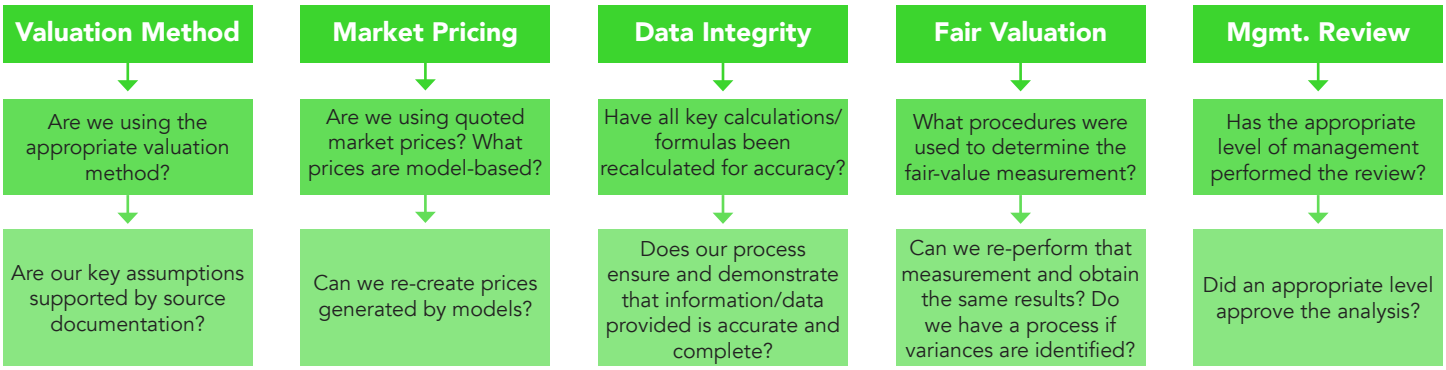
HOW CAN MANAGEMENT BETTER PREPARE FOR AUDITORS' QUESTIONS?

Inevitably, this feedback will impact the business. Although management usually performs these procedures, they may not keep records supporting the procedures they perform. In some cases, management may trust and rely entirely upon a third-party consultant. These tips should help you prepare for auditors' questions this year and for upcoming changes.

TIP 1: Involve your auditors, both internal and external, early in the business combination process to gain an understanding of documentation and retention standards (AU Section 328).

TIP 2: Perform your own due diligence over documentation received from a third-party provider or even an internal department, to independently validate data, assumptions, calculations, and/or formulas in line with guidance provided by ASC 805.

KEY QUESTIONS TO ASK WHEN REVIEWING



Internal audit should review the process used by management to perform the third-party/in-house due diligence to validate that a comprehensive process is in place and the appropriate level of documentation is retained prior to the execution of the business combination.

TIP 3: Business combination disclosures should be reviewed by the financial reporting department (Certified Public Accountant) to ensure conformity with GAAP and ASC 805-10-50-1. Management's review must take place prior to issuance of the financial statements to validate that disclosure(s) meet the criteria outlined in the guidance: "Business Combinations Occurring During a Current Period or After the Reporting but Before the Financial Statements are Issued" and/or "The Financial Effects of Adjustments that Relate to Business Combinations that Occurred in the Current or Previous Reporting Periods" disclosures.

TIP 4: Management should identify the key control activities involved with a business combination and conduct testing as necessary to provide assurance over the identified control environment, specifically around the design and effectiveness of applicable controls performed to identify potential misstatements (AU-C Section 315 "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement").

TIP 5: Management and/or internal audit should carefully review the classification of acquired assets to confirm the classification is appropriate as this could affect the accounting treatment.

- Classification should be based on contract terms, economic conditions and company operating and accounting policies and procedures (ASC 805-20-25-6, 7, 8).
- FASB issued new guidance in 2017 (which goes into effect for public companies beginning in 2018 and all other companies in 2019) that clarifies the definition of a business, as the prior definition was broadly interpreted and difficult to apply. The updated guidance may affect accounting for acquisitions, disposals, goodwill, and consolidation.
- The guidance applies a set of three elements that must exist together to classify the entity as a business. The three elements are inputs, process, and outputs. To be a business under the new guidance, a set of assets must include an input, a substantive process that when combined generates an output.
  - **Input:** A resource that creates/develops or has the ability to contribute to the creation/ development of outputs, when one or a combination of processes are applied.
  - **Process:** A system, standard, procedure, or rule that when combined with an input generates an output. These processes are usually documented by management.
  - **Output:** The result of inputs and processes being applied to provide goods and/or services to a customer base.