Avoiding pitfalls in business combinations

Findings from PCAOB inspections

Over the past decade, audit quality issues have been identified by Public Company Accounting Oversight Board (PCAOB) inspections. These reviews often include comments pertaining to the audit approach over fair value measurements involving ASC Topic 805, *Business Combinations* (ASC 805).

In this document, we summarize common areas of deficiency identified in PCAOB Part I comments[1] pertaining to fair value measurements for business combinations. While these comments address deficiencies in the audit process, they often highlight areas where process risk points may exist and may provide insight for preparers regarding improvements they can make in their processes and controls over business combinations.

Identification of intangible assets acquired

One of the most fundamental, but sometimes overlooked, elements of a business combination is the proper identification of assets acquired and liabilities assumed.

PCAOB comment

During the year, the issuer acquired a business. The firm did not perform procedures to evaluate whether all identifiable assets acquired were recognized in conformity with ASC 805, beyond reading the merger agreement and purchase-price allocation that the issuer prepared and inquiring of management.

While the merger agreement and related documents may be a good starting point for identifying acquired assets and assumed liabilities, another source of information that could help develop or support the assumption is reviewing previous allocations of comparable transactions in the same industry. Such a review of acquired intangible assets can be performed using the KPMG Intangibles Spotlight tool.[2]

Assuming book value equals fair value

Once acquired assets and assumed liabilities have been identified, preparers must estimate the fair values in accordance with the guidance found in ASC Topic 820, Fair Value Measurement (ASC 820) and ASC 805. In certain circumstances, the preparer may determine that book value approximates fair value, but adequate documentation should be provided to support this assertion and any related non-GAAP policies.

PCAOB comment

Failed to perform any substantive procedures to assess the reasonableness of management's assertion that the book value of the acquired property, plant, and equipment approximated fair value.

Due to a variety of factors, it is rare that book value is reflective of the fair value of long-term tangible and intangible assets. Before making such an assumption, it would be wise to consult with a valuation specialist, especially if the asset is material to the balance sheet.

[1] Part I comments of the 2012–2019 Inspection reports for the Big Four firms were reviewed.

[2] Please contact the authors, or others within the KPMG Valuation & Business Modeling Services practice, for additional information or a demonstration of this tool.

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Customer attrition rates

Due to the subjectivity and judgment involved, one of the most cited issues with intangible asset valuations is the customer attrition rate assumption.

Related PCAOB comments

Insufficiently tested the attrition rate by only inquiring of management and performing a sensitivity analysis.

No audit evidence that the assumptions underlying the estimation of the customer attrition rates used in the valuation were reasonable.

Failed to consider data related to companies that were comparable to the issuer.

When supporting attrition rate assumptions, generally speaking, the more data the better. With recent advancements in technology, there is no longer a need to limit the analysis of a large data set to a subset of customers. For example, KPMG has developed an application to automate the process of calculating attrition rates without being restricted to a record limit.

In situations where limited historical data is available, it may be necessary to supplement the analysis by looking at other data points such as benchmarking to attrition rates observed for similar businesses of the preparer. In some industries, customer attrition rates and useful life assumptions may be disclosed in the footnotes of comparable company SEC filings that could be helpful in assessing the reasonableness of an attrition rate assumption.

Completeness and accuracy of underlying data

One common area of scrutiny centers around the controls in place pertaining to the completeness and accuracy of the data relied upon by the appraiser in the valuation analysis. Examples of this may include detailed expense data, historical or projected financial information, historical attrition rates, growth rates, or margin data.

Related PCAOB comments

Failed to sufficiently test the accuracy and completeness of certain data used to value the acquired intangible assets, because procedures were limited to comparing certain of these data to schedules the issuer had obtained from the acquired company.

Did not test the accuracy and completeness of data used to determine the fair values of obligations assumed.

Failed to sufficiently test the accuracy and completeness of the data used to develop certain significant assumptions used to determine the fair value and amortization periods of the intangible assets.

To minimize this risk, one could review the data request list provided by the valuation specialist and confirm that each item provided has been reviewed for completeness and accuracy and the controls around that process have been well documented. It is also important to understand other key inputs relied upon by the valuation specialists and confirm the necessary controls are in place and well documented for any additional data used. Ideally, this would be done in accordance with the Application of the Mandatory Performance Framework (AMPF) for the Certified in Entity and Intangible Valuations™ Credential (CEIV).[3]

Summary

This document illustrated some of the common issues arising in PCAOB inspections involving purchase accounting. Hopefully, by addressing these matters during the valuation process, financial statement preparers may be able to minimize unwanted surprises during future audits of business combinations.

Additional resources

For additional insight into business combinations and the CEIV credential, be sure to check out these additional resources:

— KPMG Business Combination Guide

— Avoiding Pitfalls in Business Combinations

— Financial Reporting Valuations

— What is the CEIV and why does it matter for fair value measurements?

[3] For additional background on the CEIV's AMPF, see What is the CEIV & why does it matter for fair value measurements?

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Through our industry specialization, we understand the issues, value drivers, leading practices, and trends that shape the future of a particular industry, company, or business problem.

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