

# Scenario Analysis:

## Audit Considerations and Procedures for a Business Combination

### ► Purpose

This memorandum outlines the background, applicable accounting guidance, key audit challenges, and detailed audit procedures related to the acquisition of Company Y by Company X.

### ► About the Company and transaction:

Company X, incorporated in the United States of America, operates as a wholesaler of linens to chain stores throughout the United States and Canada. During the year ended March 31, 20XX, the Company acquired 100% of the outstanding equity interest in Company Y. The total consideration paid by the Company to the selling equity holders for the acquired interest was \$10mn.

### ► GAAP references to be looked into

1. ASC 805 and IND AS 103- Business Combination

### ► Key challenges in auditing the transaction

1. Accounting and auditing of business combination
2. Auditing the purchase price allocation (PPA), with key considerations being fair auditing of the fair valuate of PPE and identification of intangibles

### ► Key audit risks in the transaction

1. Incorrect classification of the transaction as a business combination or asset acquisition
2. Misstatement of purchase consideration or allocation among assets and liabilities
3. Failure to identify or correctly value intangible assets
4. Inaccurate fair valuation of PPE or identified intangibles due to inappropriate methodology, assumptions, or data
5. Omission of contingent liabilities or unrecorded obligations
6. Insufficient documentation of management assumptions, judgments, or board approvals

### ► Detailed audit procedures:

#### A. Auditing the transaction:

1. Before auditing the transaction, it is critical to understand the commercial and strategic rationale of the acquisition. This assists in understanding the transaction from both an operational and an accounting perspective
2. Read the share purchase agreement in sync with the minutes of board meetings and any other document entered into between both parties. Prepare a synopsis which primarily covers the acquisition date, % of ownership, purchase consideration, assets and liabilities transferred, and any other critical clauses mentioned in the agreement
3. Evaluate whether the transaction meets the definition of an asset acquisition or a business combination.
4. Document the date of acquisition requirements in accordance with GAAP
5. Obtain a breakdown of the consideration paid. Determine whether fair valuation is required to value any portion of consideration (For eg: Contingent consideration)
6. Obtain management's listing of assets acquired and liabilities assumed as of the acquisition date.
7. Perform procedures to identify unrecorded assets or liabilities. These may include legal confirmations, review of contracts, and management inquiries

## B. Auditing the fair value of PPE:

While the valuation of PPE shall require assistance from a valuation expert, the auditor should perform the following audit procedures:

1. Evaluate the competence, capabilities, and independence of the valuer
2. Reconcile the fixed assets as per the fixed asset register and the PPA report. Verify that all significant assets are included and are properly classified
3. Evaluate valuation methodologies (i.e., cost approach, market approach, or income approach) used. Verify whether the methods align with industry practice and the nature of assets
4. Test and document key assumptions used for valuing the PPE. Some of the key assumptions include useful lives, replacement cost considered, and physical deterioration. Compare these assumptions to historical data and industry benchmarks
5. Perform sensitivity analysis, if necessary, to assess the impact of changes in key assumptions on valuation outcomes.
6. If practical, perform a physical inspection of major fixed assets to verify the condition of assets

## C. Auditing the identification of intangibles:

1. Obtain an understanding of the intangibles identified by reading the agreement. Evaluate whether the asset shall meet the identifiability criteria as per GAAP
2. Evaluate the competence, capabilities, and independence of the valuer
3. Evaluate the valuation methodology used and document whether the method aligns with the nature of intangible and industry practice
4. Test significant assumptions and inputs. Certain key assumptions include revenue and expense growth rates, attrition rates, discount rates, and useful lives. Corroborate these assumptions with historical performances, approved budgets, and industry standards. Also, ensure consistency of these assumptions across the entire report
5. Perform sensitivity analysis on key assumptions where estimation uncertainty is high

## D. Other key considerations:

1. Obtain written confirmation of the completeness and accuracy of all acquisition-related information
2. Review potential tax impacts and cross-border regulatory obligations
3. Assess contingent liabilities, restructuring costs, or obligations arising from integration
4. Ensure all procedures and findings are properly documented per internal standards

## ► Summary of audit procedures for the above transaction

Sr.no	Audit areas	Key risks	Key procedures
1	Audit of transaction	Misclassification of transactions, incorrect recognition of assets/liabilities	<ul style="list-style-type: none"><li>• Understand acquisition rationale</li><li>• Review SPA and board minutes</li><li>• Document acquisition date</li><li>• Verify consideration breakdown</li></ul>
2	Purchase price allocation (PPE & Intangibles)	Over/under valuation; omission of assets; misstatement of intangibles	<ul style="list-style-type: none"><li>• Review expert valuations</li><li>• Reconcile assets</li><li>• Test key assumptions</li><li>• Perform sensitivity analysis</li></ul>
3	Management representations	Misstatement due to incomplete or inaccurate information	Obtain written confirmations of completeness and accuracy
4	Tax & regulatory	Non-compliance; unrecorded tax liabilities	Review tax implications and check regulatory compliance. Avail assistance from tax specialists wherever required.
5	Audit documentation	Lack of evidence for review	Document procedures, findings, and management responses

## ► Conclusion

The acquisition of Company Y represents a significant business combination for Company X. Auditors must exercise professional skepticism, carefully evaluate assumptions, and ensure full compliance with GAAP. Thorough documentation, review of valuation experts, and cross-verification of management information are critical to mitigating audit risk and ensuring accurate financial reporting.