Alerte de votre conseiller – IFRS

Acquisitions inversées

Février 2022

Résumé

L'équipe IFRS de Grant Thornton International a publié trois nouveaux documents concernant les acquisitions inversées (en anglais seulement) :

- *Insights into IFRS 3: Reverse Acquisitions Explained;*
- *Insights into IFRS 3: Reverse Acquisitions in Scope of IFRS 3;*
- *IFRS Viewpoint: Reverse Acquisitions Outside the Scope of IFRS 3*.

Aperçu

La série *Insights into IFRS 3* résume les domaines clés de la norme IFRS 3 *Regroupements d'entreprises* en soulignant les aspects les plus difficiles à interpréter et en examinant les caractéristiques les plus pertinentes et susceptibles d'avoir des répercussions sur votre entreprise.

Le document *Insights into IFRS 3: Reverse Acquisitions Explained*, qui suit la publication *Insights into IFRS 3: Identifying the Acquirer*, fournit des indications sur un domaine qui pose des difficultés, les acquisitions inversées.

Le document *Insights into IFRS 3: Reverse Acquisitions in Scope of IFRS 3* traite des acquisitions inversées entrant dans le champ d'application d'IFRS 3.

Quant au document *IFRS Viewpoint: Reverse Acquisitions Outside the Scope of IFRS 3*, il fournit de plus amples renseignements sur la comptabilisation d'une acquisition inversée n'entrant pas dans le champ d'application d'IFRS 3.

Ressources

Les publications susmentionnées sont jointes au présent bulletin *Alerte de votre conseiller – IFRS*.

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Insights into IFRS 3

Reverse acquisitions explained

Acquisitions of businesses can take many forms and can have a fundamental impact on the acquirer's operations, resources and strategies. These acquisitions are sometimes referred to as mergers or business combinations, and the accounting and disclosure requirements are set out in IFRS 3 'Business Combinations'.

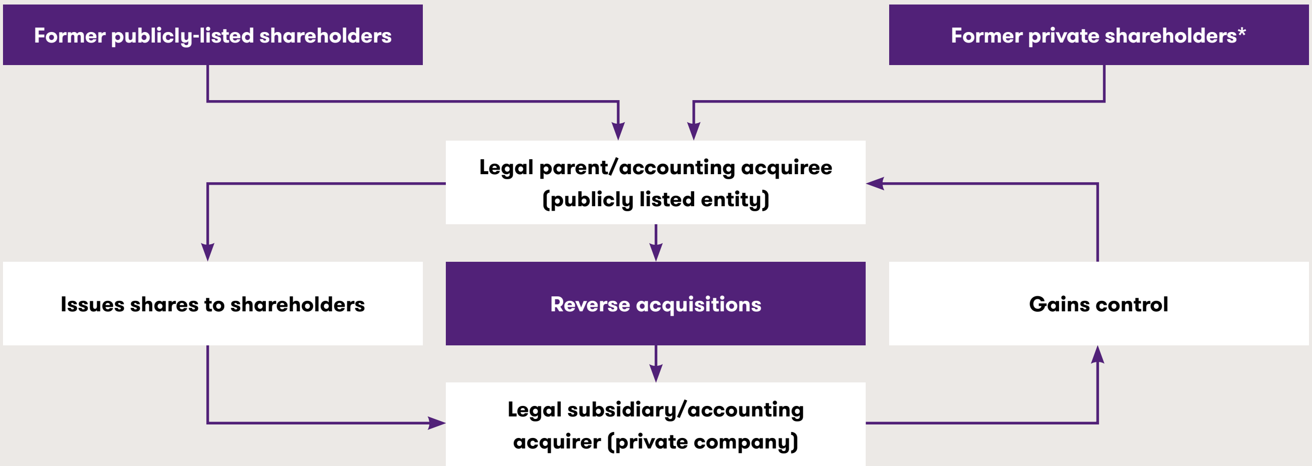
Our 'Insights into IFRS 3' series summarises the key areas of the Standard, highlighting aspects that are challenging to interpret and apply in practice. This article follows on from our published article '**Insights into IFRS 3 – Identifying the acquirer**' and presents guidance for an area which is difficult in practice – reverse acquisitions.

What is a reverse acquisition?

A reverse acquisition occurs when an entity that issues securities (the legal parent or the legal acquirer) is identified as the accounting acquiree, and accordingly, the legal subsidiary (or the legal acquiree) is identified as the accounting acquirer.

One situation in which reverse acquisitions often arise is when a private operating entity wants a fast-track to a public listing. To accomplish this, the private entity arranges for its equity interests to be acquired by a smaller, publicly listed entity. The listed entity carries out the acquisition by issuing shares to the shareholders of the private operating entity. After the exchange of shares, the former shareholders of the private entity, as a group, hold the majority of the voting rights of the combined entity. In addition, the former shareholders of the private entity then appoint the majority of the members of the new combined entity's board. In this case, although the publicly listed entity issued shares to acquire the private entity, the listed entity will be identified as the accounting acquiree and the private entity as the accounting acquirer as the former shareholders of the private entity, as a group, have obtained the control over the combined entity.

This is explained in the following diagram:



*The former private shareholders, as a group, will own the majority of the voting rights of the combined entity.

The following example illustrates the above diagram:

Example – Identifying the accounting acquirer

Entity H, an operating entity looking to become public, arranges to be acquired by Entity S, a public listed, operating company. On 30 June 20XX, Entity S acquires all the equity instruments of Entity H in consideration of the issuance of 2.5 shares for each ordinary share of Entity H. All of Entity H's shareholders exchange their shares in Entity H.

The statement of financial position for both Entity S and Entity H before the transaction are as follows:

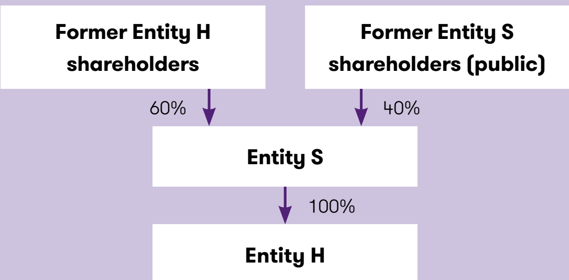
	Entity S	Entity H
Current assets	800	900
Non-current assets	1,200	3,500
Total assets	**2,000**	**4,400**
Current liabilities	400	800
Non-current liabilities	500	1,200
Total liabilities	**900**	**2,000**
Shareholders' equity		
Retained earnings	500	1,200
Issued equity		
200 ordinary shares	600	–
120 ordinary shares	–	1,200
Total shareholders' equity	**1,100**	**2,400**
Total liabilities and shareholders' equity	**2,000**	**4,400**

As Entity H has 120 ordinary shares outstanding at the date of the transaction, Entity S issues 300 ordinary shares in exchange for all the ordinary shares of Entity H (120 ordinary shares x 2.5).

Following the transaction:

- Entity S has 500 ordinary shares outstanding
- The former shareholders of Entity H own, as a group, 60% of the combined entity (300/500 ordinary shares)
- The former shareholders of Entity S own, as a group, 40% of the combined entity (200/500 ordinary shares)

This is illustrated below:



Assuming that for a shareholder to obtain control over Entity S, it needs to own the majority of the ordinary shares, in the current example, this means Entity S is the accounting acquiree (even if it issues the ordinary shares) and Entity H, the legal subsidiary, is the accounting acquirer.

This is explained by the fact that as the former shareholders of Entity H, as a group, owns the majority of the ordinary shares of the combined entity and Entity H has obtained effective control over Entity S. As such Entity S is considered, for accounting purposes, to have been acquired by Entity H. This transaction is therefore a reverse acquisition.

Is the reverse acquisition transaction a business combination?

Answering this question involves determining:

- which company is the '**accounting acquirer**' under IFRS 3, ie the company that obtains effective control over the other, and
- whether or not the acquired company (ie the 'accounting acquiree') is a **business** as defined in IFRS 3.

Identifying the acquirer

When a transaction between entities is carried out primarily by exchanging shares, the entity that obtains the control over the other entity is the accounting acquirer. Although IFRS 3 indicates to use the guidance in IFRS 10 to identify such acquirer, in practice, the factors listed in IFRS 3 with regards to the transactions effected by an exchange of equity interests should also be analysed. Refer to our article **'Insights into IFRS 3 – Identifying the acquirer'** for more details on this guidance.

The following facts and circumstances are likely to indicate the legal subsidiary is the accounting acquirer:

- the former shareholders of the legal subsidiary, as a group, retain or receive the largest portion of the voting rights in the new combined entity (which include potential voting rights that could be exercised)
- the relative size (measured in, for example, assets, revenues or profit) of the legal subsidiary is significantly greater than that of the legal parent
- the former owners or managers of the legal subsidiary dominate the composition of the governing body or senior management of the combined entity.

Practical insight – Reporting entity vs legal entity

The IFRS Interpretations Committee (IFRIC) received a request to clarify whether a business (legally acquired) that is not a legal entity could be considered to be the accounting acquirer in a reverse acquisition under IFRS 3. In September 2011, the IFRIC observed that IFRS standards do not require a 'reporting entity' to be a legal entity. Therefore, an acquirer that is a 'reporting entity' but not a legal entity can be considered to be an accounting acquirer in a reverse acquisition. This IFRIC decision has raised some issues in practice on how to determine the boundaries of the assets and liabilities of the business and the nature of the equity that is transferred.

What if the legal acquirer transfers also cash?

When a legal parent pays cash to acquire shares in a subsidiary the transaction would normally be accounted for as a regular business combination, ie considering the entity that is transferring cash is the acquirer. However, in some circumstances the business combination can still be considered a reverse acquisition even if cash is transferred from the legal parent to the owners of the legal subsidiary where other facts demonstrate the legal subsidiary is finally the accounting acquirer.

An important determining factor in identifying the acquirer is control. When it is clear as part of this transaction the legal subsidiary has obtained control over the legal parent (in accordance with the definition of control as stated in IFRS 10 'Consolidated Financial Statements'), the transaction should then be accounted for as a reverse acquisition. While this is a possible scenario, and one that can be challenging to deal with in practice, we do not believe reverse acquisitions with a payment in cash are common in practice.

What is a business?

This is one of the most commonly asked application questions in practice, in part because the answer makes a significant difference to how the transaction is accounted for.

IFRS 3 includes both a definition of a business and some detailed supporting guidance.

IFRS 3's Definition of a business
A business is defined as 'An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.'

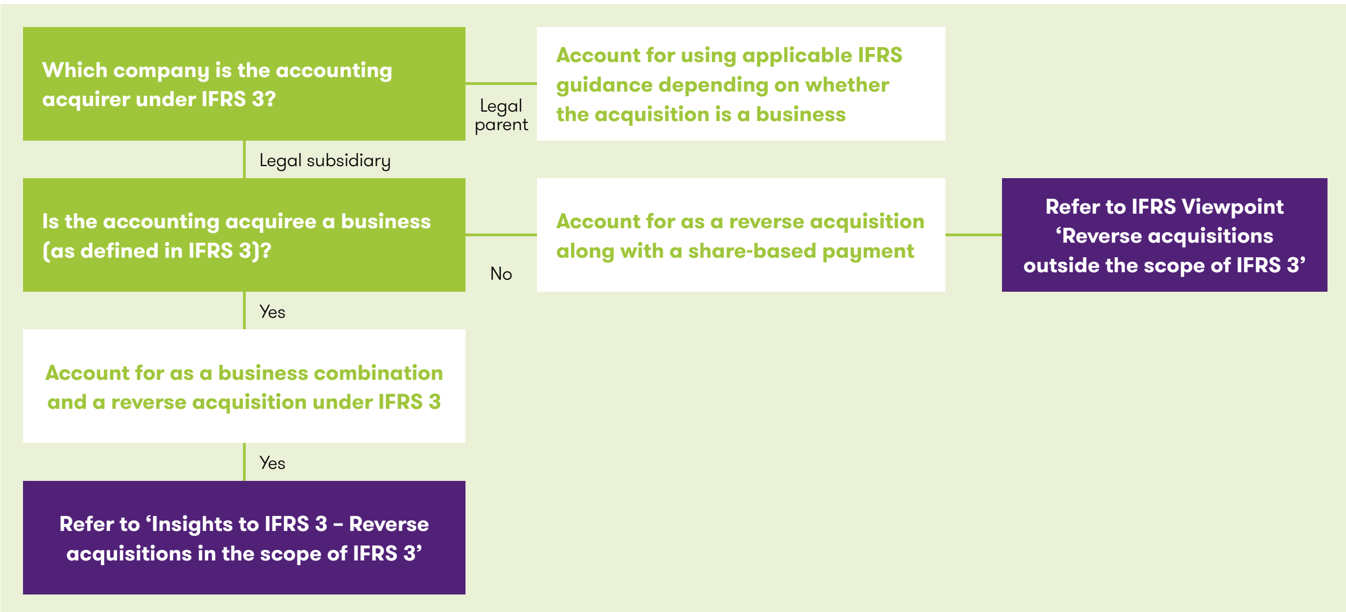
What are the minimum requirements to meet the definition of a business?
IFRS 3 acknowledges that despite most businesses having outputs, outputs are not necessary for an integrated set of assets and activities to qualify as a business. In order to meet the definition of a business, the acquired set of activities and assets must have as a minimum an input and a substantive process that can collectively significantly contribute to the creation of outputs.

Furthermore, IFRS 3 includes an optional concentration test that could be relevant in the present context. Refer to our article '**Insights into IFRS 3 – Definition of a business**' for more details, including how to apply the optional concentration test.

In our view, a listed shell company that has no current substantive operations, and whose activities mainly involved managing its cash balances and filing obligations, would not meet the criteria of a business. This is because it has no substantive processes. For this reason, we consider many transactions in which a private operating company arranges to be acquired by a listed shell company are not business combinations and therefore fall outside the scope of IFRS 3.

How to account for a reverse acquisition

The following diagram illustrates the two possible accounting treatments, with reference to the relevant publications, when facing a reverse acquisition:



How we can help

We hope you find the information in this article helpful in giving you some insight into IFRS 3. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit **www.grantthornton.global/locations** to find your local member firm.

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Insights into IFRS 3

Reverse acquisitions in the scope of IFRS 3

Acquisitions of businesses can take many forms and can have a fundamental impact of the acquirer's operations, resources and strategies. These acquisitions are described in many ways depending on the underlying facts and circumstances: mergers, takeovers and business combinations are all terms that are used, and the accounting and disclosure requirements for all of them are set out in IFRS 3 'Business Combinations'.

Our 'Insights into IFRS 3' series summarises the key areas of the Standard, highlighting aspects that are difficult to interpret and revisiting relevant features that could impact reporting entities. This article follows on from our published articles on '**Insights into IFRS 3 – Identifying the acquirer**' and '**Insights into IFRS 3 – Reverse acquisitions explained**' and presents guidance for an area which is challenging in practice – reverse acquisitions.

This article focuses on reverse acquisitions within the scope of IFRS 3. When a reverse acquisition falls outside of the scope of IFRS 3, further details on how to account for it can be found in our IFRS Viewpoint – '**Reverse acquisitions outside the scope of IFRS 3**'.

When is a reverse acquisition in the scope of IFRS 3?

Reverse acquisitions are within the scope of IFRS 3 provided the accounting acquiree is a business under IFRS 3. This Standard provides detailed guidance on what constitutes a business and what does not, and this guidance has been considered in our article **'Insights into IFRS 3 – Definition of a business'**.

How do you measure the consideration transferred in a reverse acquisition?

In a reverse acquisition, no consideration is normally issued by the accounting acquirer for the accounting acquiree. Rather, the accounting acquiree usually issues its own equity shares to the shareholders of the accounting acquirer.

In this specific situation, the fair value of the deemed consideration transferred by the accounting acquirer needs to be determined. This fair value should be determined based on the number of equity interests the legal subsidiary (accounting acquirer) would have had to issue to give the owners of the legal parent (accounting acquiree) the same percentage of equity interest in the combined entity that results from the reverse acquisition.

In certain cases, at the time of the reverse acquisition, the legal parent (accounting acquiree) may have outstanding stock options issued in share-based payment transactions. In this case, the rationale applied for determining the consideration transferred according to the guidance set out above should also be followed for the existing share-based payment award granted by the legal parent. When doing this, the guidance provided in IFRS 3 on equity-settled share-based payment transactions of the accounting acquiree should be applied, with the legal subsidiary being identified as the accounting acquirer and the legal parent the accounting acquiree. This means the vested portion of the outstanding stock options of the legal parent (accounting acquiree), although they may not be changed as a result of the reverse acquisition, will be included in the deemed consideration transferred by the accounting acquirer as if these awards had been exchanged for a share-based payment award of the accounting acquirer. The accounting for outstanding stock options issued in share-based payment transactions of the legal parent (accounting acquiree) is explained in more detail in our separate article '**Insights into IFRS 3 – Adjustments for transactions not part of the business combination**'.

Example 1 – Measuring the consideration transferred in a reverse acquisition

Entity H, an operating entity looking to become public, arranges to be acquired by Entity S, a public listed company which is also an operating entity. On 30 June 20XX, Entity S, acquires all the equity instruments of Entity H in consideration of the issuance of 2.5 shares for each ordinary share of Entity H. All of Entity H's shareholders exchange their shares in Entity H for the shares issued by Entity S.

The statements of financial position for both Entity S and Entity H before the reverse acquisition are as follows:

	Entity S (legal parent, accounting acquiree)	Entity H (legal subsidiary, accounting acquirer)
Current assets	800	900
Non-current assets	1,200	3,500
Total assets	**2,000**	**4,400**
Current liabilities	400	800
Non-current liabilities	500	1,200
Total liabilities	**900**	**2,000**
Shareholders' equity		
Retained earnings	500	1,200
Issued equity		
200 ordinary shares	600	–
120 ordinary shares	–	1,200
Total shareholders' equity	**1,100**	**2,400**
Total liabilities and shareholders' equity	**2,000**	**4,400**

In addition:

- The fair value of each ordinary share of Entity H at 30 June 20XX is CU30.
- The fair values of Entity S's identifiable assets and liabilities at 30 June 20XX are the same as their carrying amounts, except that the fair value of Entity S's non-current assets at 30 June 20XX is CU1,400.

Analysis

Entity S issues 300 ordinary shares and therefore H's shareholders now own 300/500 of the ordinary shares – 60% of the combined entity. The remaining 40% is owned by Entity S shareholders.

In order to calculate the deemed consideration transferred, Entity H needs to calculate how many shares it would have issued if it had been an acquisition made in a regular way. Entity H would have needed to have issued 80 ordinary shares to Entity S shareholders in order for Entity H's shareholders to own 60% of the combined entity (120 out of the now 200 issued ordinary shares) and for the shareholders of Entity S to own 40% of the combined entity (80 out of the now 200 ordinary shares).

Therefore, the fair value of the deemed consideration transferred by Entity H, the accounting acquirer, is CU2,400 (which is 80 shares at CU30).

It should also be noted IFRS 3 requires the effective measurement of the consideration transferred to be based on the most reliable measure available. Therefore, if a quoted market price was available for the valuation of the legal parent's shares, this would meet the criteria set out in the Standard and this should be used in the calculation.

How do you measure goodwill arising from a reverse acquisition?

In a reverse acquisition in the scope of IFRS 3, the acquisition method should be applied even if the legal parent is the accounting acquiree. This means that goodwill is measured as the excess of the fair value of the deemed consideration transferred over the fair value of the accounting acquiree's identifiable assets acquired and liabilities assumed.

Fair value of deemed consideration transferred by the legal subsidiary (accounting acquirer)	−	**Fair value of the accounting acquiree's identifiable assets acquired and liabilities assumed**	=	**Goodwill**

Example 2 – Measuring goodwill

Continuing with the previous example, goodwill would be calculated as follows (accounting for income tax effects are ignored):

	CU	CU
Fair value of the deemed consideration transferred by Entity H (refer to example 1)		2,400
Entity S's assets and liabilities recognised		
Current assets	800	
Non-current assets	1,400	
Current liabilities	(400)	
Non-current liabilities	(500)	
		(1,300)
Goodwill		**1,100**

How is a reverse acquisition presented in consolidated financial statements?

Consolidated financial statements for a reverse acquisition	
Issued under the name of	**The legal parent** (accounting acquiree)
Disclosed in the notes as	A continuation of the financial statements of the **legal subsidiary** (accounting acquirer)
Retroactive adjustments of	The legal subsidiary's (accounting acquirer) legal capital to reflect the legal capital of the **legal parent** (accounting acquiree)
	The comparatives of these consolidated financial statements to reflect the legal capital of the **legal parent** (accounting acquiree).

Therefore, the elements of the consolidated financial statements reflect:

Consolidated Financial statement elements	Are
Assets and liabilities of legal subsidiary (accounting acquirer)	Recognised and measured at their pre-combination carrying amounts
Assets and liabilities of the legal parent (accounting acquiree)	Recognised and measured in accordance with IFRS 3
Retained earnings and other equity balances	Reflective of the balances of the legal subsidiary (accounting acquirer) **before** the business combination
Amount recognised as issued equity interests in the consolidated financial statements	Determined in accordance with the formula below
Owners of the legal subsidiary (accounting acquirer) that did not exchange their equity interests in the legal subsidiary for equity interests in the legal parent (non-controlling interest) – refer to page 6 for how to account for non-controlling interest in a reverse acquisition)	Reflected at their proportionate interest in the legal subsidiary's (accounting acquirer's) carrying amounts of retained earnings and other equity interests before the business combination (ie net assets).

Amount recognised as issued equity interests in the consolidated financial statements				
the issued equity interest of the legal subsidiary (accounting acquirer) outstanding immediately before the business combination	+	**the fair value of the legal parent (accounting acquiree)**	=	**the amount recognised as issued equity interests**

An important aspect to be mindful of is the equity structure (ie the number and type of equity interests issued) should reflect the equity structure of the legal parent (accounting acquiree), including equity interests the legal parent issued to carry out the business combination. This will have the effect that the equity structure of the legal subsidiary (accounting acquirer) should be restated using the exchange ratio established in the acquisition agreement to reflect the number of shares the legal parent (the accounting acquiree) issued in the reverse acquisition. Even though the equity structure should be retrospectively adjusted, any shares issued or cash transferred as a result of the reverse acquisition should only be reported in the consolidated financial statements at the time transactions occur.

The fair value of the legal parent (accounting acquiree) could be determined either by measuring the fair value of the equity interest the accounting acquirer would have issued to effect the business combination; or by measuring the fair value of the listed shares issued by the legal parent. The method used would be based on the most reliable measure available.

Example 3 – Consolidated financial statements
Continuing with the example, the consolidated financial position at 30 June 20XX is:

	Consolidated CU
Current assets (CU800 + CU900)	1,700
Goodwill	1,100
Non-current assets (CU1,400 + CU3,500)	4,900
Total assets	**7,700**
Current liabilities (CU400 + CU800)	1,200
Non-current liabilities (CU500 + CU1,200)	1,700
Total liabilities	**2,900**
Shareholders' equity	
Retained earnings (Entity H)	1,200
500 Ordinary shares (CU1,200 + CU2,400)	3,600
Total shareholders' equity	**4,800**
Total liabilities and shareholders' equity	**7,700**

The issued equity balance in the consolidated statement of financial position is made up of Entity H's (legal subsidiary, accounting acquirer) issued equity immediately prior to the business combination (CU1,200) plus the fair value of the deemed consideration transferred (CU2,400). Also, as shown, the issued equity of the accounting acquirer may need to be restated if it does not reflect the equity structure of the legal parent. In this case, the equity structure reflected in the consolidated financial statements would be 500 ordinary shares. This is calculated by adding 200 (Entity S's (legal parent) capital structure before the business combination) to 300 (the number of equity instruments effectively issued by Entity S).

How is non-controlling interest in a reverse acquisition accounted for?

In a reverse acquisition, some of the owners of the legal subsidiary (accounting acquirer) may decide not to exchange their equity interests for equity interests of the legal parent (accounting acquiree). Those owners are treated as a non-controlling interest in the consolidated financial statements after the reverse acquisition.

This is because the owners of the legal subsidiary (accounting acquirer) that do not exchange their equity interests for equity interests of the legal parent have an interest in only the results and net assets of the legal subsidiary and not in those of the combined entity. However, even though the legal parent is the acquiree for accounting purposes, the owners of the legal parent have an interest in the results and net assets of the combined entity.

As noted above, the assets and liabilities of the legal subsidiary (accounting acquirer) are measured and recognised in the consolidated financial statements at their carrying amounts immediately prior to the business combination. Therefore, in a reverse acquisition the non-controlling interest reflects the non-controlling shareholders' proportionate interest in the carrying amounts of the legal subsidiary's net assets prior to the business combination even if non-controlling interests in other acquisitions are measured based on the fair value at the acquisition date of these assets and liabilities.

Example 4 – Non-controlling interest

In the example previously presented, if only the shareholders owning 110 shares out of the total 120 outstanding shares chose to exchange their shares non-controlling interest would need to be recognised. Entity S would issue 2.5 shares for every Entity H share so it would issue 275 shares instead of 300 shares (110 shares x 2.5). So H's shareholders who agree to proceed with the exchange would own 275 out of the 475 shares now issued, which is 57.9%.

Similar to the previous example presented, Entity H would need to calculate how many shares it would have issued if the business combination had been effected in a more regular way by giving the owners of Entity H the same percentage of S equity interest. Entity H would have issued 80 shares to Entity S's shareholders in order for Entity H's shareholders to own 57.9% as Entity H's shareholders would own 110 out of the now 190 issued shares.

Therefore, as the number of shares that would have been issued and the price have not changed, the fair value of the consideration transferred does not change compared to the previous example provided. It remains at CU2,400 which represents 80 shares at CU30.

The non-controlling interest is represented by the 10 out of the 120 shares that have not been exchanged by Entity H shareholders into Entity S shares. Therefore, the non-controlling interest is calculated to be 8.3% (10/120). This amount of controlling interest needs to be adjusted in the consolidated statement of financial position to reflect the pre-combination amounts of Entity H.

This is demonstrated as follows:

	Previous Example	Adjustment for Non-Controlling Interest	Revised Consolidated
Current assets (800 + 900)	1,700	–	1,700
Goodwill	1,100	–	1,100
Non-current assets (1,400 + 3,500)	4,900	–	4,900
Total assets	**7,700**	**-**	**7,700**
Current liabilities (400 + 800)	1,200	–	1,200
Non-current liabilities (500 + 1,200)	1,700	–	1,700
Total liabilities	**2,900**	**-**	**2,900**
Shareholders' equity			
Retained earnings	1,200	(100)	1,100
475 Ordinary shares (1,200 +2,400)	3,600	(100)	3,500
Non-controlling interest (see below)		200	200
Total shareholders' equity	**4,800**	**-**	**4,800**
Total liabilities and shareholders' equity	**7,700**	**-**	**7,700**

The non-controlling interest is calculated as follows:

Pre-combination equity of Entity H	Pre-combination balances		Non-controlling interest percentage		Non-controlling interest
Retained earnings	1,200	X	8.3%	=	100
Issued capital	1,200	X	8.3%	=	100
Total shareholders' equity	**2,400**	**X**	**8.3%**	**=**	**200**

How do you calculate earnings per share after a reverse acquisition?

As previously indicated on page 4, the equity structure in the consolidated financial statements following a reverse acquisition should reflect the equity structure of the legal parent (the accounting acquiree), including the equity interests issued by the legal parent to carry out the business combination. However, whereas the number of shares taken into account for the period after the reverse acquisition is based on the legal parent capital structure, the historical number of shares of the legal parent should not be used in calculating the earnings per share before the reverse acquisition. As the legal subsidiary is the accounting acquirer, the number of shares to use in the earnings per share calculations for the period before the reverse acquisition should be based on the weighted average number of outstanding shares of the accounting acquirer before the business combination adjusted to reflect the exchange ratio applied in the reverse acquisition.

Profit or loss amounts (numerator of the earnings per share calculation)

The profit or loss of the accounting acquirer (legal subsidiary) should be used for comparative period and the current period between the beginning of the period and the date of the transaction. The consolidated profit or loss of the legal parent (accounting acquiree) is only included from the date of the reverse acquisition.

Weighted average number of ordinary shares (the denominator of the earnings per share calculation)

The weighted average number of ordinary shares outstanding during the period in which the reverse acquisition occurs should be calculated as follows:

number of ordinary shares outstanding from the beginning of that period to the reverse acquisition date = **weighted average number of ordinary shares of the legal subsidiary (accounting acquirer) outstanding during the period before the reverse acquisition** ✖ **exchange ratio applied in the reverse acquisition**

+

number of ordinary shares outstanding from the reverse acquisition date to the reporting date = **weighted average number of actual ordinary shares of the legal parent (the accounting acquiree) outstanding after the reverse acquisition**

=

weighted average number of ordinary shares outstanding for the period

The weighted average number of ordinary shares outstanding for the comparative period(s) presented should be calculated as follows:

weighted average number of ordinary shares outstanding of the legal subsidiary (accounting acquirer) for the comparative period	**×**	**exchange ratio applied in the reverse acquisition**

Example 5 – Earnings per share
Continuing with the previous example, assume Entity H's net profits were CU1,250 and CU800 for 20XX and 20X0 respectively and that Entity S generated a net profit of CU50 after the date of the reverse acquisition.

Also assume Entity H's outstanding share capital for the current and previous periods was as follows:

		20XX	20X0
Beginning of annual period		100	80
Issuance of shares	30 April	20	
	30 June		20
End of annual period		120	100

Calculation of basic earnings per share (EPS):

		20XX		20X0
Net profit		CU1,250		CU800
Weighted average number of shares	(a)	383	(b)	225
Basic EPS		CU3.26		CU3.56

Calculation of the weighted average number of shares:
(a) 20XX

Period	Calculation	CU
6 months to 30 June 20XX	100 X 6/12 months + 20 × 2/12 months	53
	X exchange ratio	2.5
		133
6 months to 31 December 20XX	(300 + 200) X 6/12 months	250
Total weighted average number of shares		**383**

(b) 20X0

Period	Calculation	CU
Year to 31 December 20X0	80 X 12/12 months + 20 X 6/12 months	90
	X exchange ratio	2.5
Total weighted average number of shares		**225**

How we can help

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IFRS Viewpoint

Reverse acquisitions outside the scope of IFRS 3

What's the issue?

Private operating companies seeking a 'fast track' stock exchange listing sometimes arrange to be acquired by a smaller listed company (often described as a 'shell' company). This usually involves the listed shell company issuing its shares to the private company shareholders in exchange for their shares in the private operating company. A transaction in which a company with substantial operations ('operating company') arranges to be acquired by a listed shell company should be analysed to determine how it should be accounted for under IFRS.

The '**Insights into IFRS 3 – Reverse acquisitions explained**' article introduces situations in which mergers and acquisitions are accounted for as reverse acquisitions and how they should be accounted for – either as a business combination under IFRS 3 'Business Combinations' or as an asset acquisition (if what is being acquired is not a business). This IFRS Viewpoint sets out the accounting issues related to reverse acquisitions that are out of the scope of IFRS 3.

Our 'IFRS Viewpoint' series provides insights from our global IFRS team on applying IFRS in challenging situations. Each edition focuses on an area where the Standards have proved difficult to apply or lack guidance.

Relevant IFRS

IFRS 3 'Business Combinations'

IFRS 2 'Share-based Payment'

IFRS 10 'Consolidated Financial Statements'

IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'

IAS 27 'Separate Financial Statements'

The IFRIC agenda decision

The guidance in this IFRS Viewpoint is consistent with the accounting treatment concluded in the IFRIC decision made in March 2013 as follows:

IFRS Interpretations Committee (IFRIC) guidance

The IFRIC considered the accounting for this type of transaction in various meetings in 2012 and 2013. The IFRIC decided not to develop a formal Interpretation but did publish a detailed 'agenda decision' setting out its view on the correct accounting (in March 2013).

The IFRIC observed that IFRS 3's guidance on identifying the accounting acquirer and on reverse acquisitions would be applied by analogy based on the hierarchy set out in IAS 8 'Accounting Policies, Changes in Accounting Policies and Errors'. The IFRIC also commented that a reverse acquisition transaction in which the accounting acquiree is listed but is not a business is a share-based payment transaction within the scope of IFRS 2 'Share-based payment'. Accordingly, any excess of the fair value of shares deemed to be issued by the accounting acquirer over the fair value of the accounting acquiree's recognisable net assets should be expensed. This is because the excess fair value represents a share-based payment made in exchange for obtaining a listing.

Practical tip – Special purpose acquisition companies

In certain jurisdictions, small companies are listed for the purpose of seeking to carry out a transaction which could be in the form of a merger, capital stock exchange, asset acquisition, stock purchase or similar combination with one or more non-listed operating entities. These entities are either directly created for that purpose or are former operating entities that divested their operations in order to change their purpose. These entities are known under different names, such as 'Special purpose acquisition company' (or 'SPAC') or 'Capital Pool Corporation' (or 'CPC').

Based on the IFRIC decision, applying the following steps will help to determine how to account for the reverse acquisition.

Is the reverse acquisition transaction a business combination?

Answering this question involves determining:
- which company is the ‘accounting acquirer’ under IFRS 3, ie the company that obtains effective control over the other, and
- whether or not the acquired company (ie the ‘accounting acquiree’) is a business as defined in IFRS 3.

In a transaction where an operating entity is arranged to be acquired by a shell listed company the pre-combination shareholders of the operating company usually obtain, as a group, a majority (controlling) interest in the controlled entity, with the pre-combination shareholders of the listed shell company retaining a minority (non-controlling) interest. The resulting shareholding often indicates that the operating company is the accounting acquirer and the listed shell company the accounting acquiree.

Where the listed company is identified as being the accounting acquiree, the next step is to determine whether it is a ‘business’ as defined in IFRS 3. In our view, this would not probably be the case if its activities mainly consist in managing cash balances and filing obligations. Further analysis will be needed if the listed company undertakes other activities and holds other assets and liabilities associated with those other operations.

If the facts show an operating company is obtaining effective control over a listed company that is not a business, the acquisition cannot be regarded as a business combination and it is therefore outside the scope of IFRS 3.

Accounting for a reverse acquisition when the transaction is not a business combination

Since IFRS 3 does not apply, management should apply IAS 8, and when doing so refer to the IFRIC March 2013 agenda decision mentioned above to account for the reverse acquisition. The substance of the transaction is the accounting acquirer (operating company) has made a share-based payment to acquire a listing along with the listed company’s cash balances and other net assets (if any). The transaction should therefore be accounted for in accordance with IFRS 2.

In addition, although a reverse acquisition involving a ‘non-business’ listed company is not a business combination, the listed company still becomes a legal parent and continues to have filing obligations. Accordingly, as required by IFRS 10 ‘Consolidated Financial Statements’ the legal parent has to prepare consolidated financial statements. Based on the IFRIC agenda decision, these consolidated financial statements would be prepared using some of the guidance in IFRS 3 on reverse acquisition, but without recognising goodwill. Specifically:
- the consolidated financial statements of the legal parent (listed shell company) are presented as a continuation of the financial statements of the operating company (the legal subsidiary, which is considered the accounting acquirer)
- the transaction price is allocated to the identifiable assets and liabilities of the listed shell company on the basis of their fair values at the date of purchase
- any excess of the transaction price over the fair value of the assets and liabilities of the listed shell company represents a cost for obtaining a listing. This is accounted for as an expense as it does not represent an asset under IFRS, and
- no goodwill is recognised.

This approach allows the accounting acquiree (listed company) to satisfy its filing obligations, and to prepare consolidated financial statements that reflect the substance of the transaction.

Can the accounting simply follow the legal form?
As the transaction is outside IFRS 3's scope, some might question whether that Standard's guidance on identifying an acquirer and reverse acquisition accounting is relevant. Would it instead be acceptable to account for the acquisition based on its 'legal form' and treat the legal parent as the accounting acquirer? With such an approach, questions remain as to:

- how the identifiable assets and liabilities of the legal subsidiary should be brought into the consolidation (eg at previous carrying amount or at fair value)? and
- whether or not any goodwill should be recognised?

Our view is this 'legal-form-based' accounting is unlikely to reflect the substance of the transaction or to provide the most relevant information. This is because this accounting would result in:

- 'losing' the financial history of the operating company (which is relevant to the users of financial statements)
- fair valuing the identifiable assets and liabilities of the operating company when, in substance, no change of control over that company has occurred
- potentially recognising goodwill (which is not appropriate outside a business combination), and
- accounting that is inconsistent with the IFRIC agenda decision mentioned on page 2.

Measuring the components of the reverse acquisition transaction

As indicated above, this type of reverse acquisition is a share-based payment transaction from the point of view of the accounting acquirer. Considering it is a share-base-payment transaction, guidance in IFRS 2 on the measurement of equity-settled transactions should be followed.

Under IFRS 2, equity-settled transactions should be measured at the fair value of the assets and services acquired, if this fair value is reliably determinable. Such fair value corresponds to the fair value of the accounting acquiree as a whole, (ie the listed entity) that holds those assets and services acquired (ie the net assets acquired) which include identifiable net assets and possibly unidentified assets or services, such as costs of listing. Thus, the accounting acquirer is deemed to have acquired the shares of the listed entity, not only the identifiable net assets of the listed entity. If the fair value of the shares of the listed entity can be measured reliably, then the fair value of the net assets acquired including any associated services should correspond to the fair value of the outstanding shares of the listed shell company just before the transaction. This fair value is part of the transaction price that will have to be allocated to the identifiable net assets and any unidentified assets or services.

However, if the fair value of the shares of the listed company cannot be estimated reliably, then the transaction should be measured based on the fair value of the consideration given up. Because the accounting acquirer is not the entity that has issued the equity instruments from a legal perspective, it is necessary to determine the consideration given up (or the deemed transaction price) by calculating the deemed number of shares the accounting acquirer would have had to issue to obtain control over the listed shell company as if it had directly acquired the shares of the listed shell company. This deemed number of shares issued should then be multiplied by the fair value of a share of the accounting acquirer just before the transaction.

In certain cases, the listed shell company may have stock options outstanding at the time of the reverse acquisition. IFRS 2 does not provide any guidance on how to deal with this situation. However, IFRS 3 does have guidance on how to treat equity-settled share-based payment transactions of the accounting acquiree in a business combination. Although, this type of reverse acquisitions is out of scope of IFRS 3, we believe the guidance in IFRS 3 can be applied by analogy. Vested stock options of the accounting acquiree will need to be measured in accordance with IFRS 2 and included in the transaction price (or the deemed transaction price). If the stock options are not fully vested, only the vested portion of the stock options should be included in the transaction price. The unvested portion will represent future share-based compensation.

The identifiable assets and liabilities (net assets) of the listed shell company will have to be measured at their fair value at the date of transaction and as a result a difference between the transaction price and the fair value of the identifiable net assets of the accounting acquiree may arise. See below on how to account for this difference.

Treatment of excess of transaction price over the identifiable net assets acquired

IFRS 2 indicates any difference between the fair value of the transaction price and the fair value of any identifiable net assets received represents a service received by the issuer of the shares, or in the present case a service received by the accounting acquirer. Therefore, the excess of the transaction price over the cash balances and other net identifiable assets acquired is a cost of services for obtaining a listing (in accordance with the IFRIC 'agenda decision' mentioned on page 2).

We do not believe the cost of obtaining a listing is an intangible asset (or any other type of asset). This is because listing is a status attaching to the company's shares rather than being an asset controlled by the company itself. The cost of listing should therefore be accounted for as an expense in the consolidated statement of profit or loss.

> "Under IFRS 2, equity-settled transactions should be measured at the fair value of the assets and services acquired, if the fair value is reliably determinable."

Earnings per share after the reverse acquisition

As previously indicated, the listed company becomes a legal parent and continues to have filing obligations. The equity structure in the consolidated financial statements following a reverse acquisition should therefore reflect the equity structure of the legal parent (the accounting acquiree), including the equity interests issued by the legal parent to carry out the reverse acquisition. However, due to the particular nature of reverse acquisitions as discussed below, the use of the historical number of shares of the legal parent may not make sense when calculating the earnings per share after the reverse acquisition. Therefore, even though such reverse acquisitions are not within the scope of IFRS 3, the guidance on the calculation of earnings per share in IFRS 3 could be applied by analogy.

Whereas the number of shares taken into account for the period after the reverse acquisition is based on the legal parent capital structure, considering the guidance under IFRS 3 could be applied in this case, the historical share numbers of the legal parent should not be used in calculating the earnings per share before the reverse acquisition. As the legal subsidiary is the accounting parent, the number of shares to use in the earnings per share calculations for the period before the reverse acquisition should be based on the weighted average number of outstanding ordinary shares of the accounting parent before the transaction, adjusted to reflect the exchange ratio applied in the reverse acquisition.

Profit or loss numbers (numerator of the earnings per share calculation)

The profit or loss of the accounting parent (legal subsidiary) should be used for comparative period and the current period before and after the date of the transaction. The profit or loss of the legal parent (accounting acquiree) is only included from the date of the reverse acquisition.

Weighted average number of ordinary shares (the denominator of the earnings per share calculation)

The weighted average number of ordinary shares outstanding during the period in which the reverse acquisition occurs should be calculated as follows:

number of ordinary shares outstanding from the beginning of the reporting period to the reverse acquisition date = **weighted average number of ordinary shares of the legal subsidiary (accounting acquirer) outstanding during the reporting period before the reverse acquisition** × **exchange ratio applied in the reverse acquisition**

\+

number of ordinary shares outstanding from the reverse acquisition date to the reporting date = **weighted average number of actual ordinary shares of the legal parent (the accounting acquiree) outstanding after the reverse acquisition**

=

weighted average number of ordinary shares outstanding for the period

The weighted average number of ordinary shares outstanding for the comparative period(s) presented should be calculated as follows:

weighted average number of ordinary shares outstanding of the legal subsidiary (accounting acquirer) for the comparative reporting period × **exchange ratio applied in the reverse acquisition**

Example 1 – Reverse acquisition accounting

ShellCo (a listed entity) has divested all of its operations. Its current activities are limited to managing its cash balances and filing obligations.

OpCo is a substantial operating entity that wishes to obtain a 'fast track' listing. The summarised balance sheets of OpCo and ShellCo immediately prior to the transaction are:

	ShellCo CU000s	OpCo CU000s
Cash	300	5,000
Other net assets	–	45,000
	300	**50,000**
Issued share capital, 100,000 shares	1,000	–
Issued share capital, 10,000 shares	–	10,000
Retained earnings (losses)	(700)	40,000
	300	**50,000**

Both entities have a period-end date of 31 December.

On 1 August 20X1, ShellCo acquires 100% of the issued share capital of OpCo by issuing 990 shares for each share in OpCo (9.9m new shares issued in total). Post-combination, the ownership ratios are therefore:

- ShellCo's former shareholders: 1% (100,000/10,000,000 shares)
- OpCo's former shareholders: 99% (9,900,000/10,000,000 shares)

Therefore, Opco is the accounting acquirer and Shellco is the accounting acquiree. The transaction is a share-based payment transaction whereby Opco acquires the net assets of Shellco that is not a business.

ShellCo's share quoted market price immediately before the transaction was CU5 per share. Hence the total fair value of ShellCo is CU500,000. Prior to the transaction, OpCo's management obtains a valuation of its shares of CU5,000 per share.

Transaction price

Since the transaction is regarded as an equity-settled transaction under IFRS 2, an entity measures the assets received, and the corresponding increase in equity, directly at the fair value of the assets received. If the entity cannot measure reliably the fair value of the assets received, the entity measures the amounts, indirectly, by reference to the fair value of the equity instruments issued. As the accounting acquirer is deemed to have acquired the shares of the listed entity (or deemed net assets acquired), not only the identifiable net assets of the listed entity, the fair value of the shares of the listed entity should be used to measure the transaction price.

As the quoted market price of ShellCo's shares is available this is used to calculate the transaction price. The transaction price is therefore CU500,000 (100,000 of ShellCo's shares with a fair value per share of CU5).

This amount of CU500,000 is then split as follows:

- CU300,000 represents payment for ShellCo's cash balances, and
- the difference (CU200,000) is a cost for obtaining a listing.

In this example ShellCo's only asset is cash with a balance of CU300,000 which is also its fair value. When the accounting acquiree has other assets or liabilities, these should also be recognised at their fair values. The excess between the transaction price and the total fair value of identified assets and liabilities of Shellco is considered to be the cost of the listing.

In situations where the fair value of the deemed net assets acquired cannot be estimated reliably, the transaction should be measured based on the fair value of the consideration given up, ie the 'deemed' transaction price for obtaining control over ShellCo. This should be determined from the perspective of OpCo. However, OpCo has not actually paid anything from a legal perspective. As a result, it is necessary to calculate:

- the number of shares OpCo would have issued to obtain control over ShellCo in a 'straight' acquisition, and
- the fair value of this number of OpCo shares.

Example 1 – Reverse acquisition accounting (continued)
The first step is to determine how many shares OpCo would have had to issue to ShellCo's shareholders to give them a 1% ownership interest in Opco, with OpCo's shareholders retaining a 99% interest (ie the same ownership ratio that results from the actual transaction). In this example, OpCo would have had to issue 101 shares [(10,000/0.99) - 10,000]. The second step is to estimate the fair value of the 101 shares deemed to be issued by OpCo. The fair value of the equity instruments that would have been issued would be CU505,000 (101 shares with a fair value per share CU5,000).

In this example, it is assumed transaction costs are immaterial and therefore have been ignored.

A straightforward approach to accounting for the transaction is for ShellCo's financial statements to be presented as a continuation of OpCo's financial statements, with the following entries to give effect to the transaction:

Date of combination	Debit CU000s	Credit CU000s
Cash – balance acquired from ShellCo	300	–
Costs of listing (income statement)	200	–
Equity	–	500

Earnings per share calculation
Assume Opco's net profit was CU2,750,000 and CU1,500,000 for 20X1 and 20X0 respectively and that there is no net profit in Shellco starting from the date of the reverse acquisition.

Also assume that Opco's outstanding share capital for the current and previous periods was as follows:

		20X1	20X0
Beginning of annual period		8,000	5,000
Issuance of shares	30 April	2,000	–
	30 June	–	3,000
End of annual period		10,000	8,000

Calculation of basic earnings per share (EPS):

		20X1		20X0
Net profit		CU2,750,000		CU1,500,000
Weighted average number of shares	(a)	9,281,667	(b)	6,435,000
Basic EPS		CU0.30		CU0.23

Calculation of the weighted average number of shares:
(a) 20X1

Period	Calculation	CU
Before 1 August 20X1	8,000 X 7/12 months + 2,000 × 3/12 months	5,167
	X exchange ratio	990
		5,115,000
After 1 August 20X1	(9,900,000 + 100,000) X 5/12 months	4,166,667
Total weighted average number of shares		**9,281,667**

(b) 20X0

Calculation	CU
5,000 X 12/12 months + 3,000 X 6/12 months	6,500
X exchange ratio	990
Total weighted average number of shares	**6,435,000**

Disclosures

IFRS 2 requires extensive disclosures about share-based payments. The overall disclosure objective is to provide information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements during the period.

However, many of the detailed IFRS 2 disclosures are not relevant for this type of transaction. Nonetheless, management should determine which IFRS 2 disclosures are applicable.

Example 2 – Disclosures

As part of the Re-organisation on 1 August 20X1, Shellco entered into a share exchange transaction (the "Transaction") with Opco whereby each shareholder of Opco exchanged its common shares in Opco on a 990:1 basis for common shares of Shellco. Furthermore, on 1 August 20X1, in connection with the Transaction, all former option holders of Shellco exchanged their options on a 990:1 basis for new options in Opco, on substantially similar terms to their original options in Shellco.

In accordance with IFRS 3, the substance of the acquisition is a reverse acquisition as the shareholders of Opco hold the majority of the shares of Shellco. The acquisition of Shellco does not constitute a business combination as Shellco does not meet the definition of a business under IFRS 3. As a result, the acquisition is accounted for in accordance with IFRS 2, with Opco being identified as the acquirer and the net asset of Shellco deemed acquired. The consideration of the Transaction is measured at fair value of the shares and stock options of Shellco that are outstanding just before the Transaction. Accordingly, the resulting balances and transactions for the periods prior to 1 August 20X1 are those of Opco.

The consideration transferred is as follows:

	CU
100,000 shares issued and outstanding of Shellco (a)	500,000
Fair value of options issued to officers and directors of Shellco (b)	5,000
Total consideration transferred	**505,000**

a The fair value of the consideration in the Transaction is determined be reference to the quoted share price of Shellco at CU5 per share.

b The fair value of the stock options has been estimated at CU5,000 using the Black-Scholes option pricing model with the following assumptions:

- Risk-free interest rate 1.35%
- Expected dividend yield Nil
- Expected volatility 100%
- Expected life 1 year

The allocation of the consideration transferred to the net assets acquired by Opco is as follows:

	CU
Cash	300,000
Listing costs expensed	205,000
	505,000

Separate financial statements

If the legal parent prepares separate financial statements (in addition to consolidated financial statements), reverse acquisition accounting does not apply. The legal parent should apply the normal IAS 27 'Separate Financial Statements' approach when preparing its separate financial statements.

How we can help

We hope you find the information in this IFRS Viewpoint helpful in giving you some insight into a complex IFRS area. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit **www.grantthornton.global/locations** to find your local member firm.

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