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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."

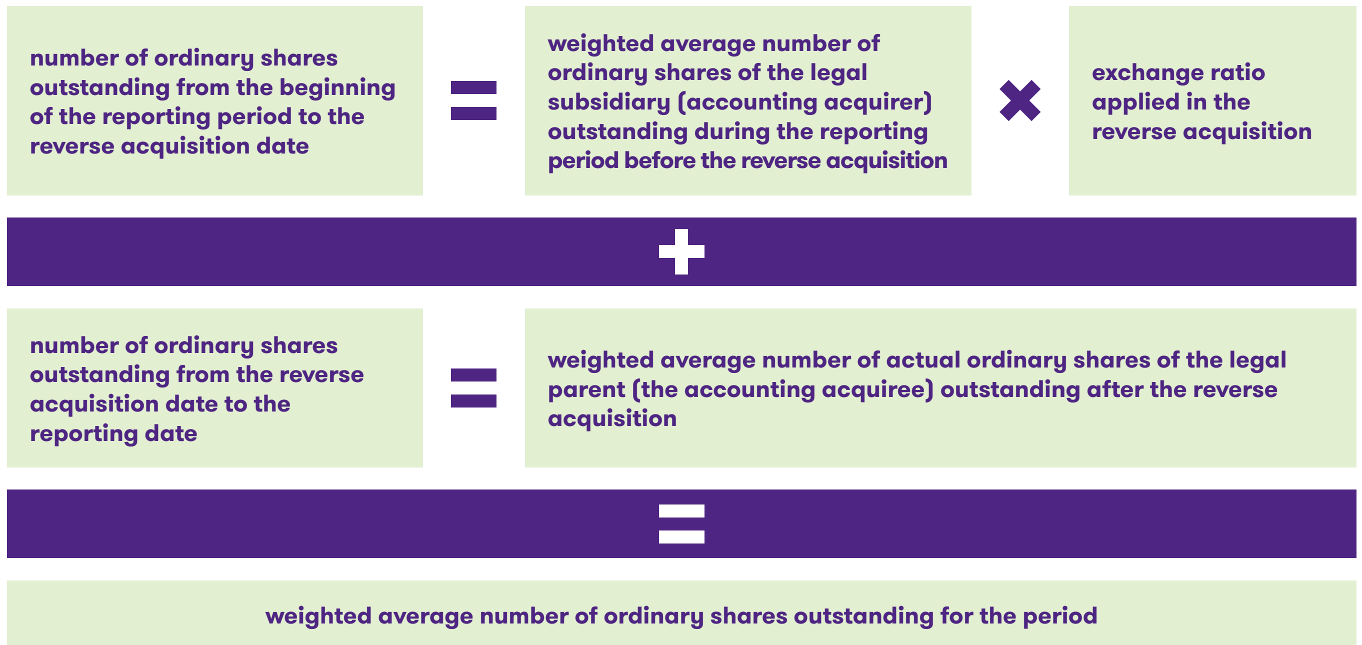
Earnings per share after the reverse acquisition

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.

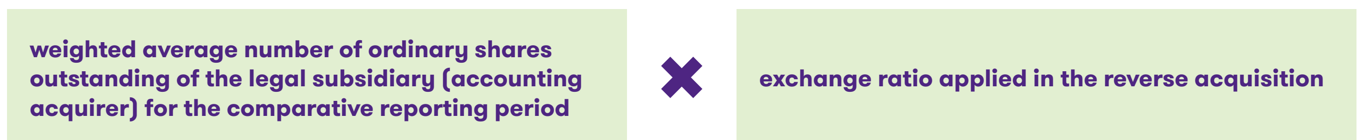
Whereas the number of shares taken into account for the period after the reverse acquisition is based on the legal parent capital structure, considering the guidance under IFRS 3 could be applied in this case, the historical share numbers of the legal parent should not be used in calculating the earnings 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:



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



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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