Grant Thornton

Accounting

Advisory

Global

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

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.

grantthornton.global