

IFRS Viewpoint

Reverse acquisition by a listed company

Our 'IFRS Viewpoint' series provides insights from our global IFRS team on applying IFRSs in challenging situations. Each edition will focus on an area where the Standards have proved difficult to apply or lack guidance. This edition considers the reverse acquisition by a listed company.

What's the issue?

Private operating companies seeking a 'fast track' stock exchange listing sometimes arrange to be acquired by a smaller listed company (sometimes described as a 'shell' company). This usually involves the listed company

issuing its shares to the private company shareholders in exchange for their shares.

How should these transactions be accounted for? The IFRS Viewpoint gives you our views.

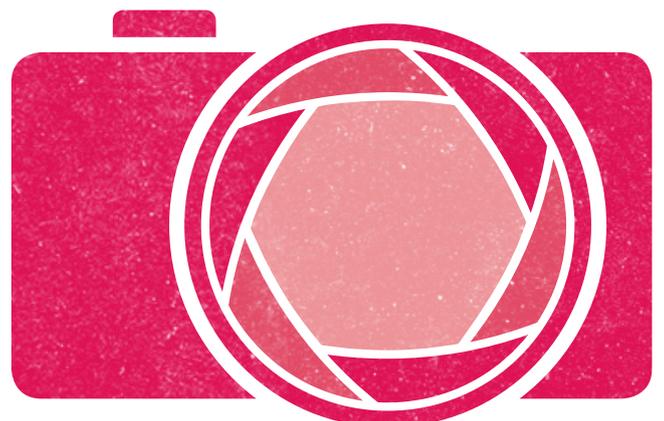
Relevant IFRSs

IFRS 3 Business Combinations

IFRS 2 Share-based Payment

IAS 27 Separate Financial Statements

IAS 8 Accounting Policies, Changes in Accounting
Estimates and Errors



Our view

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 IAS 8 hierarchy. 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. 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.

The accounting described in this IFRS Viewpoint is consistent with the IFRIC's agenda decision.

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 if it is a business combination within the scope of IFRS 3.

Is the 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

- whether or not the acquired company (ie the 'accounting acquiree' under IFRS 3) is a business.

In these transactions, the pre-combination shareholders of the operating company typically obtain a majority (controlling) interest, with the pre-combination shareholders of the listed shell company retaining a minority (non-controlling) interest. This usually indicates that the operating company is the accounting acquirer.

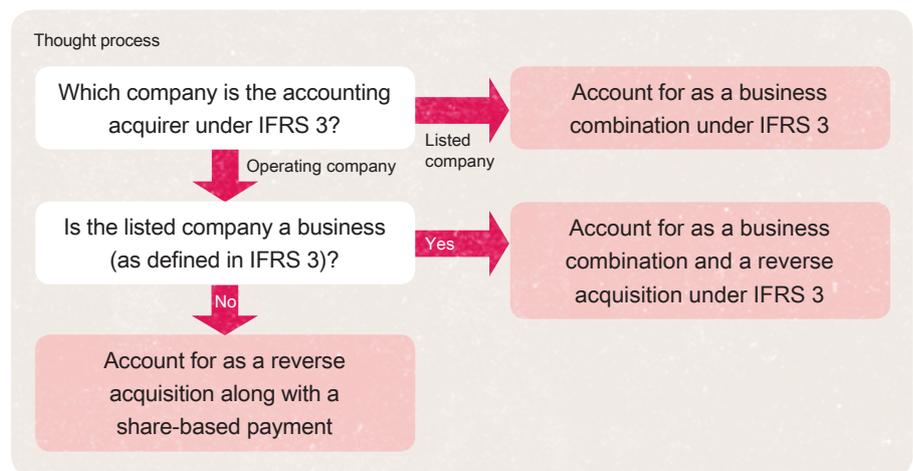
If the listed company is the accounting acquiree, the next step is to determine whether it is a 'business' as defined in IFRS 3. In our view, the listed company is not a business if its activities are limited to managing cash balances and filing obligations. Further analysis will be needed if the listed company undertakes other activities and holds other assets and liabilities. Determining whether the listed company is a business in these more complex situations typically requires judgement.

An acquisition in which an operating company obtains effective control over a listed company that is not a business is not a business combination (IFRS 3.2(b)). It is therefore outside the scope of IFRS 3.

Accounting when the transaction is not a business combination

Although a reverse acquisition of a 'non-business' listed company is not a business combination, the listed company becomes a legal parent and continues to have filing obligations. Accordingly, IFRS 10 requires it to prepare consolidated financial statements. In our view, these consolidated financial statements should be prepared using reverse acquisition methodology, 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 deemed acquisition cost (see Example section) should be allocated to the identifiable assets and liabilities of the listed shell company on the basis of their fair values at the date of purchase (see Example section)
- any excess of the deemed acquisition cost over the fair value of the assets and liabilities of the listed shell company represents a share-based payment made in exchange for obtaining a listing. This should be accounted for as an expense in accordance with IFRS 2
- in some rare situations, the total fair value of identified assets and liabilities may exceed the deemed cost. If so, the recognised values of the assets and liabilities should be reduced on a pro-rata basis so that they equal the deemed acquisition cost (IFRS 3.2(b))
- any other transaction costs incurred should be allocated between the costs of a new issue of equity shares and the cost of obtaining a listing
- no goodwill is recognised.



Accounting when the transaction is a business combination

When the listed company is the accounting acquirer and is also a business for IFRS 3 purposes, IFRS 3's reverse acquisition approach applies in full (see IFRS 3.B19-B27). Goodwill is then recognised to the extent the deemed acquisition cost exceeds the fair value of the listed company's identifiable assets and liabilities. Although some of the deemed acquisition cost might in substance relate to the cost of obtaining a listing, this amount is subsumed into goodwill.

When the listed company is identified as the accounting acquirer, the normal IFRS 3 acquisition accounting principles apply. The diagramme above summarises the thought process.



More analysis

Operating companies seeking a 'fast track' stock exchange listing sometimes arrange to be acquired by a smaller listed company. The listed company then issues shares to the private company shareholders in exchange for their shares in the private company. The listed company becomes the 'legal parent' of the operating company, which in turn becomes the 'legal subsidiary'.

If the operating company is more valuable than the listed company, the former shareholders of the operating company should receive more than 50% of the post-transaction shares in the listed company. This usually indicates that the operating company is the accounting acquirer.

Identifying the accounting acquirer

The guidance in IFRS 10 should be used to identify the acquirer, ie the company that obtains control of the acquiree (IFRS 3.7 and B13). If the guidance in IFRS 10 does not clearly indicate the acquirer, the factors in paragraphs IFRS 3.B14-B18 are also considered (IFRS 3.7 and B13). Indicators that the legal subsidiary is the accounting acquirer include:

- the former shareholders of the legal subsidiary as a group retain or receive the largest portion of the voting rights in the combined company (IFRS 3.B15(a))
- the relative size (measured in, for example, assets, revenues or profit) of the legal subsidiary is significantly greater than that of the other combining company or entities (IFRS 3.B16)

- the (former) owners or managers of the legal subsidiary dominate the composition of the governing body or senior management of the combined company (IFRS 3.B15(c)-(d)).

Is the acquisition a business combination?

If the operating company is the accounting acquirer, the next step is to determine whether the listed company it has obtained control of meets the definition of a business.



What is a business?

This may seem an obvious or intuitive question. It is however one of the most commonly asked application questions in practice, in part because the answer makes a big difference to the accounting.

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

IFRS 3's definition of a business:

“an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants”

IFRS 3 goes on to explain that a business consists of inputs and processes applied to those inputs that have the ability to create outputs. Determining whether an investee comprises a business or an asset group is often straightforward, but not always. The supporting guidance in IFRS 3.(B7-B12) clarifies that:

- the assessment of whether the integrated set of activities and assets are capable of being managed as a business is a matter of principle and normal market practice
- it is not relevant whether the seller previously operated the set as a business or whether the acquirer intends to operate the set as a business
- similarly, a set can still be considered a business when it does not contain all the assets and activities that the seller used in operating that business, so long as market participants are capable of acquiring or otherwise providing the missing elements (for example by integrating the business with their own operations).

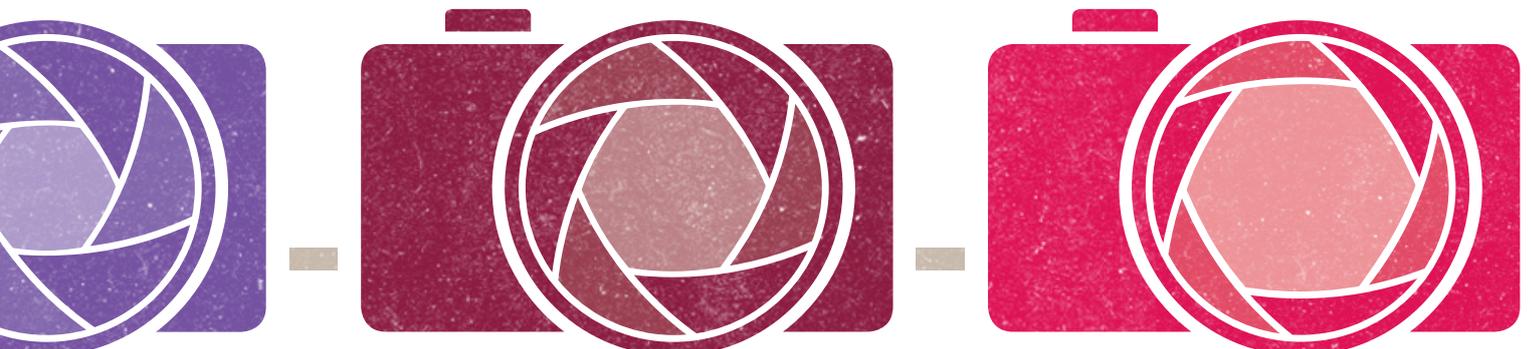
Watch this space

At the time of writing the IASB is undertaking a project to review IFRS 3's definition of a business and supporting guidance. Based on the project's current direction, we do not expect the outcome to change our view that a listed company whose activities are limited to managing cash balances and filing obligations is not a business. However, the analysis of more complex situations would be affected. The next step is an Exposure Draft – expected later in 2016.

In our view, a listed company that has divested all of its operations, and whose activities are limited to managing its cash balances and filing obligations (ie, a listed shell), is not a business. This is because it has no processes or outputs. For this reason, we consider that many transactions in which a substantial operating company arranges to be acquired by a listed shell company are not business combinations. If these transactions are not business combinations they are outside the scope of IFRS 3 (IFRS 3.2(b)).

In other reverse acquisitions the listed company might hold other assets and liabilities and undertake broader activities. If so, it might meet the definition of a business. This is sometimes a matter of judgement. If the listed company is the accounting acquiree and is also a business, the 'normal' reverse acquisition requirements of IFRS 3 apply. Goodwill is then recognised if applicable (IFRS 3. B19-27 and IFRS 3.IE1-IE15).

The rest of this IFRS Viewpoint focuses on cases in which the operating company is the accounting acquirer and the listed shell company is the accounting acquiree and is not a business.



Developing an accounting policy when the listed shell is not a business

Even though the listed company is the accounting acquiree, it is a legal parent and continues to have filing obligations. IFRS 10 therefore applies, and requires consolidated financial statements.

However, IFRS 3 does not apply. Management therefore needs to develop an accounting policy to address the basis of preparation of the consolidated financial statements. IAS 8 sets out broad principles on developing accounting policies in the absence of specific requirements, along with a 'hierarchy' of sources of guidance that management can refer to (IAS 8.7-12).

In our view the substance of the transaction is that 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). We therefore consider that the consolidated financial statements of the listed shell should be prepared as a continuation of the operating company's financial statements. In other words, IFRS 3's reverse acquisition methodology should be applied by analogy.

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)
- whether or not any goodwill should be recognised.

In any case, we consider that 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
- potentially recognising goodwill (which is not appropriate outside a business combination)
- fair valuing the identifiable assets and liabilities of the operating company when, in substance, no change of control over that company has occurred
- accounting that is inconsistent with the IFRIC's agenda decision referred to above.

Treatment of excess of acquisition cost over net assets acquired

The approach described above treats the excess of the deemed acquisition cost over the cash balances and other net assets acquired as a cost of obtaining a listing. The deemed acquisition cost is paid in shares. Accordingly, it is a share-based payment and IFRS 2 applies.

We do not believe the cost of obtaining a listing is an intangible asset (or 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. IFRS 2 therefore requires that this cost is accounted for as an expense (IFRS 2.8).

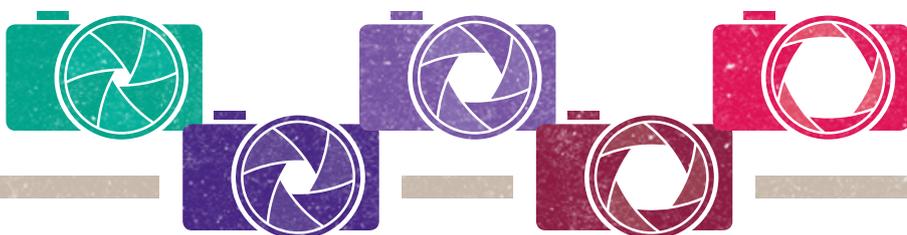
Disclosures

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 will not be relevant to the type of transaction discussed in this IFRS Viewpoint. Nonetheless, management should determine which IFRS 2 disclosures are applicable and provide them to the extent material.

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 applies the normal IAS 27 approach in its separate financial statements.



Example

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

OpCo Limited is a substantial operating company 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	250	5,000
Other net assets	–	45,000
	250	50,000
Issued share capital, 100,000 shares	1,000	–
Issued share capital, 10,000 shares	–	10,000
Retained earnings (losses)	(750)	40,000
	250	50,000

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%
- OpCo's former shareholders: 99%

ShellCo's share 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.

OpCo incurs transaction costs of CU50,000.

Deemed acquisition cost

The 'deemed' acquisition cost for obtaining control over ShellCo should be determined from the perspective of OpCo. However, OpCo hasn't actually paid anything from a legal perspective. As a result, it is necessary to calculate:

- the number of shares OpCo would have issued had it obtained control over ShellCo in a 'straight' acquisition; and
- the fair value of this number of OpCo shares.

The first step is to calculate 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 $[(10,000/0.99) - 10,000]$. In effect, we look at the transaction as the issue of 101 shares in OpCo in exchange for 100,000 shares in ShellCo.

The second step is to estimate the fair value of the 101 shares deemed to be issued by OpCo. This amount can be estimated directly as the fair value of 101 OpCo shares, or indirectly as the fair value of 100,000 ShellCo shares. If these amounts differ, the more reliable estimate should be used (IFRS 3.33 and IE5).

In accordance with the fair value hierarchy in IFRS 13, the quoted market price of ShellCo's shares is more reliable than the valuation obtained for OpCo's shares. The deemed acquisition cost is therefore CU500,000 (100,000 of ShellCo's shares with a fair value per share of CU5).

This CU500,000 is then analysed as follows:

- CU250,000 represents payment for ShellCo's cash balances
- the balance (also CU250,000) is a share-based payment for obtaining a listing.

In this example ShellCo's only asset is cash. The cash balance of CU250,000 is also its fair value. When the acquiree has other assets or liabilities, these should also be recognised at their fair values. The excess between the deemed acquisition cost and the total fair value of identified assets and liabilities is considered to be the cost of the listing.

Transaction costs

In substance, this transaction has two components: a share-based payment by OpCo in exchange for a listing and an issue of shares by OpCo for cash. The transaction costs should therefore be analysed between the two components. For the purpose of this example, it is assumed that 50% of these costs are directly attributable to the issue of shares for cash (and would have been avoided if that transaction had not occurred). These costs are deducted from equity. The balance, in other words the costs attributable to obtaining a listing, should be expensed.

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	250	
Costs of listing (income statement)	250	
Equity		500
Cash – transaction costs		50
Equity	25	
Costs of listing (income statement)	25	



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