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Accounting for reverse acquisition (Part1)

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Accounting for reverse acquisitions have always constituted an interesting topic for accountants both in theory and in practice. The importance of this topic in our environment is highlighted by the relatively increased frequency with which mergers and acquisitions have occurred in the last couple of years.

By virtue of the FRC Act of 2010, almost all entities in Nigeria are expected to be reporting based on IFRS by the end of the year and any acquisitions during this period, whether a direct acquisition or a reverse acquisition is expected to be accounted for using the guidelines provided by IFRS 3. IFRS 3 Business combinations prescribes accounting and disclosure requirements for the acquiring entity in a business combination scenario.

IFRS 3 defines a business combination as “a transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also business combinations as that term is used in this IFRS.”

IFRS 3 also expressly indicates its non-applicability to the following transactions:

- The formation of a joint venture;
- The acquisition of a group of assets that does not constitute a business; and
- A combination between entities or businesses under common control

The first stage in accounting for an acquisition is to determine whether a transaction or other event is a business combination, this requires that we assess the assets acquired and liabilities assumed if the transactions constitute a business.

The transaction or event should be analysed by applying the definition of a business combination, and the detailed guidance set out in paragraphs B5 to B12 of the Standard. The guidelines ensure that we consider aspects of the transaction that include assessing if the acquirer obtains control of a business (which means there must be a triggering economic event or transaction) and the possible resulting structures.

IFRS 3 defines a business as “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.” In most cases, it will be obvious whether an integrated set of activities and assets should be regarded as a business. But when this is not clear, it will be necessary to apply judgement, taking account of all the relevant facts and circumstances.

IFRS 3 requires that all business combinations be accounted for by applying the acquisition method. [IFRS 3:4] In addition to determining whether a transaction or other event is a business combination (IFRS 3:3), four stages in the application of the acquisition method are listed: [IFRS 3:5]

(a) identifying the acquirer;

(b) determining the acquisition date;

(c) recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; and

(d) recognising and measuring goodwill or a gain from a bargain purchase

A reverse acquisition is said to have occured when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes. Also, the entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition. Reverse acquisitions sometimes occur when a private operating entity wants to become a public entity but does not want to register its equity shares. To accomplish that, the private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity.

The guidance on identifying the acquirer (see IFRS 3:6, 3:7 and IFRS 3:B14 to B18) is relevant in a reverse acquisition transaction. It is suggested that the two primary factors that may lead to the conclusion that the transaction involves a reverse acquisition are:

(1) The former shareholders of the entity whose shares are acquired own the majority of shares, and control the majority of votes, in the combined entity; and

(2) The management of the combined entity is drawn predominantly from the entity whose shares are acquired.

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Based on the limitation of IFRS 3 business combination to circumstances when the acquiree is a business, it follows for reverse acquisitions, that the accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition. While the IFRS Interpretations Committee in September 2011 noted that neither IFRSs nor the Conceptual Framework for Financial Reporting require that a 'reporting entity' be a legal entity.

Consequently, a business that is a reporting entity, but not a legal entity, can be considered to be the acquirer in a reverse acquisition.

Accounting for the reverse acquisition

Consolidated financial statements prepared following a reverse acquisition are issued under the name of the legal parent (accounting acquiree) but described in the notes as a continuation of the financial statements of the legal subsidiary (accounting acquirer), with one adjustment, which is to adjust retroactively the accounting acquirer's legal capital to reflect the legal capital of the accounting acquiree. That adjustment is required to reflect the capital of the legal parent (the accounting acquiree). Comparative information presented in those consolidated financial statements also is retroactively adjusted to reflect the legal capital of the legal parent (accounting acquiree).

Separate financial statements for the legal parent, if required, would be prepared on a stand-alone basis. When the entity was formed shortly before the combination, its separate financial statements should cover only its actual accounting period.

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