Grant Thornton

Accounting

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Global

Insights into IFRS 3

Identifying the acquirer

Business combinations are infrequent transactions that are unique for each occurrence. IFRS 3 ‘Business Combinations’ contains the requirements and despite being fairly stable in the ten years since its been released, still provides challenges when accounting for these transactions in practice.

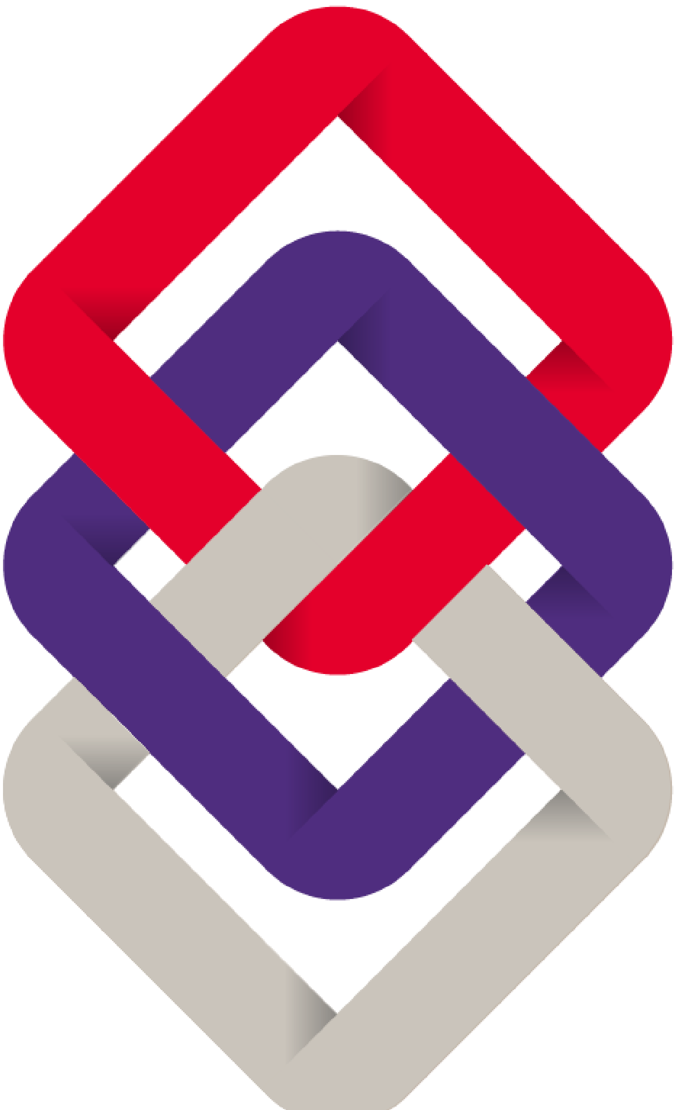
Our ‘Insights into IFRS 3’ series summarises the key areas of the Standard, highlighting aspects that are more difficult to interpret and revisiting the most relevant features that could impact your business.

The acquisition method set out in IFRS 3 is applied from the point of view of the acquirer – the entity that obtains control over an acquiree which meets the definition of a business. An acquirer must therefore be identified whenever there is a business combination. This article explains how to identify the acquirer.

This article should be read closely with our other ‘identification’ articles:

- Insights into IFRS 3 - Identifying a business combination within the scope of IFRS 3
- Insights into IFRS 3 - Identifying the acquisition date

A critical point to note is the acquirer for IFRS 3 purposes (the accounting acquirer) may not always be the legal acquirer (the entity that becomes the legal parent, typically through ownership of majority voting power in the other combining entity).



What is IFRS 3's approach to identifying the acquirer?

IFRS 3 initially directs an entity to IFRS 10 'Consolidated Financial Statements' to identify the acquirer, and to consider which entity controls the other (ie the acquiree). In most business combinations identifying the acquirer is straightforward and is consistent with the transfer of legal ownership. However, the identification can be more complex for business combinations when:

- businesses are brought together by contract alone such that neither entity has legal ownership of the other
- a combination is affected by legal merger of two or more entities or through acquisition by a newly created parent entity
- there is no consideration transferred (combination by contract), or
- a smaller entity arranges to be acquired by a larger one.

In these more complex situations, IFRS 3 takes an in-substance approach to identifying the acquirer rather than relying solely on the legal form of the transaction. This in-substance approach looks beyond the rights of the combining entities themselves. It also considers the relative rights of the combining entities' owners before and after the transaction. Combinations where the acquirer of a business is the acquiree rather than the acquirer are reverse acquisitions and IFRS 3 provides specific guidance on how to account for these. Refer to page 6 for more details.

This means if, when applying the control guidance in IFRS 10, it is not clear which of the entities being combined is the acquirer, entities should revert back to IFRS 3 which provides the following additional indicators to consider:

Factors to consider	Who is usually the acquirer?
Combination effected primarily by transferring cash, other assets or incurring liabilities	The entity that transfers cash or other assets or incurs the liabilities.
Combination effected primarily by exchanging equity interests	The entity that issues the equity interests. However, see more considerations in the table on page 5.
Relative size or more than two entities involved	The entity whose size is significantly greater than that of the other combining entity or entities.
A new entity is formed to effect a business combination	If the new entity is formed to issue equity interests, one of the existing combining entities is usually the acquirer. See more considerations in the table on page 3. If the new entity transfers cash or other assets or incurs liabilities, the new entity may be the acquirer.

Examples involving the creation of a new entity

In practice, one of the most common situations where the process of identifying the acquirer requires a more in-depth analysis is when a new entity is formed to bring about a business combination. This can be done in many ways and sometimes can result in a ‘reverse acquisition’ which is explained on page 6. Below are situations of when a new entity might be formed to bring about a business combination:

In-depth analysis when a new entity is formed to bring about a business combination

New parent pays cash to bring about a business combination (Example 1)	New entity is created to acquire a business by issuing shares (Example 2)	New entity is created by the existing shareholders to hold their subsidiaries – in this situation there is no acquirer as it is a business combination under common control.

Example 1 – New parent pays cash to bring about a business combination

New unrelated investors are wishing to take control of Entity X, and it uses a newly formed entity (NewCo) to effect this transaction. The new investors have invested cash in NewCo in exchange for shares in NewCo. NewCo then acquires all the shares in Entity X using the cash it has obtained from its new shareholders.

Old Shareholders	**New investors**	**New investors**
↓	↓	↓
Entity X	**NewCo**	**NewCo**
		↓
		Entity X

Analysis

In this situation, Newco uses the cash it has obtained from its new shareholders to effect the acquisition of Entity X.

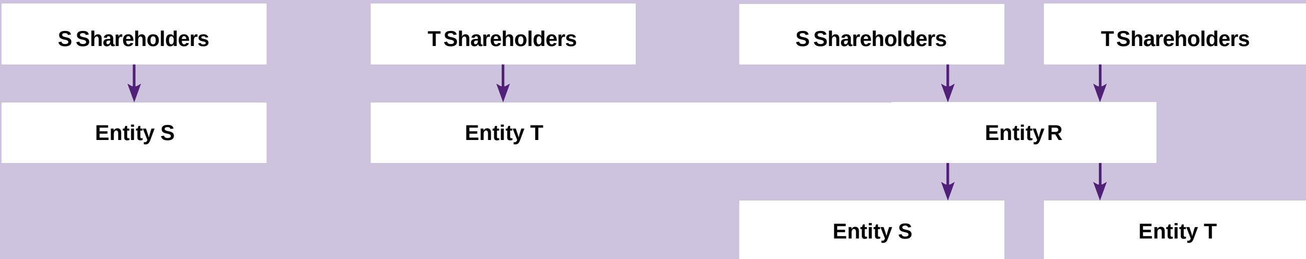
Although NewCo is a newly formed entity, NewCo is identified as the acquirer not only because it paid cash but also because with the help of new investors, NewCo has been able to obtain control of Entity X from its previous shareholders. NewCo is effectively considered an extension of the new investors, which ultimately used NewCo to gain control over Entity X.

This analysis would be similar when evaluating special purpose acquisition companies (SPACs) which are new companies created by investors (including managers or experienced business executives) with the objective to raise significant funds through an IPO to effect an acquisition of a target in a specific sector and/or area.

Example 2 – New entity is created to acquire a business by issuing shares

Entity S, a company with its own retail division, plans to expand its operations by acquiring another retailer, Entity T. Entity T's retail operations are smaller and less valuable than Entity S. To effect the acquisition, S and T Shareholders (who which are unrelated), agree to form a new entity, Entity R, and to transfer their shares in each respective entity to Entity R in exchange for Entity R shares.

After the transfer, Entity R owns 100 % of Entity S and Entity T equity interests. The former shareholders of Entity S collectively hold the majority of the equity shares of Entity R. In addition, former S Shareholders, as a group, have the right to appoint four of the six directors of Entity R. The remaining two directors are appointed by former T Shareholders, as a group. Entity R will prepare its own IFRS consolidated financial statements.



Analysis

Based on the legal form of the transactions, it appears that Entity R acquired two retail businesses (the retail company Entity S and the smaller retailer Entity T) in exchange for its own shares. However, when a new entity is formed to issue shares to effect a business combination between two businesses, IFRS 3 requires that one of the businesses being combined be identified as the acquirer. The identification of the acquirer in this situation requires management to determine which of the former shareholders of each entity being combined, as a group, has retained control of its entity.

In this example, Entity S is deemed to be the acquirer because it is the entity whose former shareholders collectively retain or receive the largest portion of the voting rights in the new combined entity, and they are able to appoint four out of six directors of Entity R.

"IFRS 3 initially directs an entity to IFRS 10 'Consolidated Financial Statements' to identify the acquirer, and to consider which entity controls the other (ie the acquiree)."

Business combination effected by exchanging equity interests

When considering a combination effected primarily by exchanging equity interests, other factors and circumstances shall also be considered such as:

Factors to consider	Who is usually the acquirer?
Relative voting rights in the combined entity	The entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity (see Example 3 below).
Existence of a single large minority interest in the combined entity	The entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity, if no other owner or organised group of owners has a significant voting interest.
Composition of the governing body of the combined entity	The entity whose owners have the ability to elect or appoint or remove a majority of the members of the governing body of the combined entity.
Senior management of the combined entity	The entity whose (former) management dominates the combined management.
Terms of the exchange of equity interest	The entity that pays a premium over the pre-combination fair value of the equity interest of the other combining entity or entities.

It is important to note there is only ever one acquirer in a business combination. In those that involve more than two entities, it is important to consider which entity initiated the combination and the relative size of the combining entities.

Example 3 – Merger of four companies and their relative voting rights

Four companies decide to group their businesses and to do so, they decided to merge together and form NewCo. This is to create economies of scale. Each company has agreed to contribute their business to NewCo in exchange for shares in NewCo. The characteristics of the four companies are as follows:

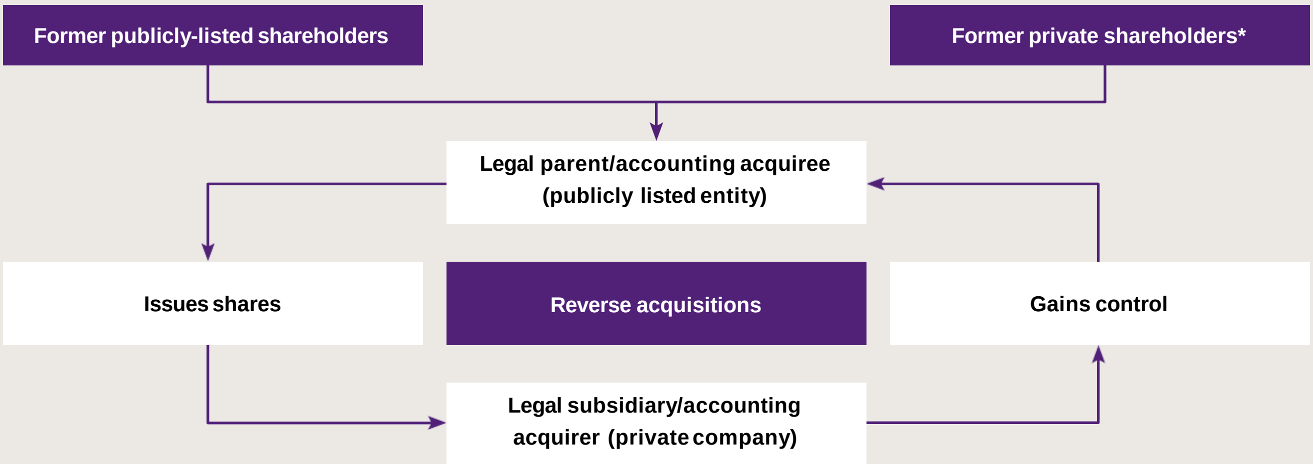
- all 4 companies run independent cafés all in the same region
- Company A runs 3 café's and Company's B, C and D have one each
- Company A is given 40% of the voting rights, and B, C and D are given 20% each, and
- there are no other factors to indicate who the acquirer is.

In this situation, Company A is the acquirer. Usually, the entity whose owners obtain the largest portion of the capital of the combined entity generally also has the ability to elect the majority of the members to the governing body.

Reverse acquisitions

Another common situation where the process of identifying the acquirer requires some in-depth analysis is when shares are exchanged, and the result is that the accounting acquirer is not the legal acquirer. Normally it is the entity who issues shares to acquire a business who obtains the control of the business it acquired. It is then identified as the acquirer. However, it could happen that following the issuance of the shares by the entity (legal acquirer), it is instead the legal subsidiary that is identified as the acquirer. These are known as reverse acquisitions.

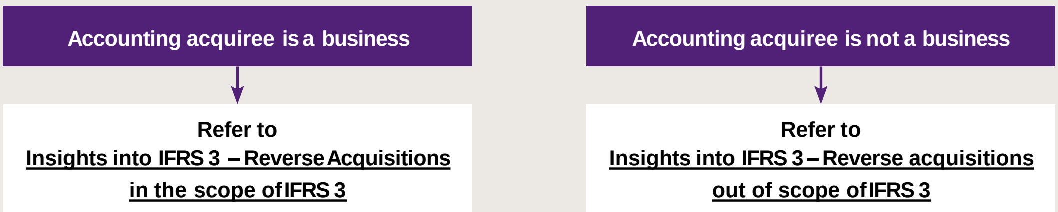
One situation in which reverse acquisitions often arise is when a private operating entity is looking for a fast-track to a public listing. To accomplish this, the private entity arranges for its equity interests to be acquired by a smaller, publicly-listed entity. The listed entity effects the acquisition by issuing shares to the owners 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 have appointed 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. This is because the former shareholders of the private entity, as a group, have retained control over the private entity.



*The former private shareholders will own the majority of the voting rights of the combined entity.

The accounting for reverse acquisitions depends on whether the accounting acquiree is a business. When the accounting acquiree is a business, the recognition and measurement principles in IFRS 3 apply, including the requirement to recognise goodwill. If the accounting acquiree is not a business, then it is outside the scope of IFRS 3.

As this topic is a challenging one in practice, we have a published separate guidance on this, including examples, as follows:



Business combinations by contract alone

When a business combination is achieved by contract alone, such as a stapling arrangement, with no combining entity obtaining control of the other combining entities, the acquirer should usually be the combining entity whose owners (as a group) receive the largest portion of the voting rights in the combined entity. This matter was considered by the IFRIC and an agenda decision confirming this accounting treatment was issued in May 2014.

Our Team

Our team of IFRS experts have supported the IFRS implementation programme for a wider range of our clients across the Gulf. To navigate the complexities of the standard and to ensure you are fully compliant by the deadline of January 2023 contact us.

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Jatin, the Senior Partner of Grant Thornton Abdulaal, has over 15 years of experience in the field of internal audit, business assurance, and special advisory for local and multinational clients. Prior to joining Grant Thornton, he was associated with Lovelock & Lewes, India (a member firm of Price Waterhouse Coopers - India) & Chartered Accountants firm M/s Kalyaniwalla & Mistry (a member firm of Ernst & Young). Jatin is actively involved in each assignment from its business development phase up to the final deliverables for ensuring all deliverables comply with Grant Thornton International quality standards. His qualifications are: CA (ICAI India), MBA Finance (India), CFC (USA), and CRMA, (IIA USA).

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Yaser, a Partner at Grant Thornton Abdulaal, has over 10 years of experience in audit and assurance, internal audit, risk assessment, corporate governance, process analysis and documentation, and policies and procedures development. Prior to joining Grant Thornton, he was associated with Gulf International Bank and Ernst and Young in Bahrain. He joined GIB's internal audit department at a critical stage in the bank's strategy implementation, which allowed him a very unique opportunity to participate in the launch of the new Retail Bank in KSA. Yaser was involved in the overhaul of existing policies and procedures which were replaced with newly developed process flow maps, policies and procedure manuals. At Ernst and Young, he led assurance service delivery to a portfolio of investment and retail banks. He is an ACCA, CIA, CFSA, and CIPA. He is also a member of IIA.

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Chris, a Partner at Grant Thornton Abdulaal, has over 14 years of post qualification experience in the field of audit and assurance services. Prior to joining Grant Thornton, he was a Senior Associate in SyCip, Gorres, Velayo & Co. (SGV & Co.), a member firm of Ernst & Young in the Philippines. Chris is currently the head of Audit Quality at Grant Thornton Abdulaal. He is a Certified Public Accountant (CPA-Philippines) and finished his degree (BS Accountancy) in the Philippines.

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Ali has been associated with the firm since 2005. He has over 14 years of experience in engagement management, assurance services, risk advisory services and business process solutions. As a part of Grant Thornton's audit and assurance services division, he is responsible for coordination and supervision of projects. His key responsibilities on assignments include managing teams responsible for risk assessment, engagement planning, execution, delivery and engagement closure. Ali has conducted and managed projects and services offered to entities across different sectors and industries. His geographical experience spans across Bahrain and Saudi Arabia. He is a qualified CPA (USA), CGMA and holds a Certificate in Financial Reporting Standards (IFRS).

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Sameer, Senior Manager - Audit at Grant Thornton – Abdulaal, has over 12 years of experience in auditing a range of listed, multinational and local clients in several industries including manufacturing, real estate, trading, services, commercial and investment banking, leasing, insurance and mutual funds. Prior to joining Grant Thornton Abdulaal, Sameer was associated with Grant Thornton Dubai and Grant Thornton Pakistan. He is responsible for managing and monitoring audit engagements. He is an ACA – Associate member of Institute of Chartered Accountants of Pakistan (ICAP), APFA – Associate member of Pakistan Institute of Public Finance Accountants (PIPFA), and ACPA – Associate member of Institute of Certified Public Accountants of Pakistan (ICPAP).

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.bh.**

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