# TEN WAYS TO MATERIALLY MISSTATE YOUR FINANCIAL STATEMENTS…THE 'BLIND FREDDY' PROPOSITION CONTINUED - PART 8 – REVERSE ACQUISITIONS AND FRESH START ACCOUNTING

## Reverse acquisitions

Despite International Financial Reporting Standards (IFRSs) being applied in Australia since 2005, it would appear that Australian accountants still struggle to recognise a reverse acquisition or to pick up 'fresh start' accounting.

Failing to properly identify the correct acquirer in a transaction can lead to material errors as a result of incorrectly fair valuing the assets and liabilities of the genuine acquirer (effectively recognising internally generated goodwill) and showing incorrect comparatives, EPS, etc.

Typical reasons for failing to recognise a reverse acquisition include:

- Percentage holdings of legal parent and accounting parent are very close
- Cash is injected at the same time that the reverse acquisition takes place
- Construction of a group involving more than two entities.

**Example 1:**
Listed company Junior Ltd enters into a 'merger' with Good Prospect Pty Ltd. At the beginning of the transaction, Junior Ltd has 1,000,000 shares on issue. It issues an additional 1,000,000 shares to acquire 100 per cent of the share capital of Good Prospect Pty Ltd. The new board will consist of four directors, two each from Junior Ltd and Good Prospect Pty Ltd. The new chairman, who will have a casting vote, is the former chairman of Good Prospect Pty Ltd.

In the above example, Good Prospect Pty Ltd is the accounting parent, its assets should not be fair valued, and all comparative information should be that of Good Prospect Pty Ltd.

**Example 2:**
Listed company Junior Ltd enters into a 'merger' with Good Prospect Pty Ltd. At the beginning of the transaction, Junior Ltd has 1,000,000 shares on issue. It issues an additional 1,200,000 shares to acquire 100 per cent of the share capital of Good Prospect Pty Ltd. Concurrently with the merger, Junior Ltd issues 500,000 shares and raises $5m. The new board will consist of four directors, two each from Junior Ltd and Good Prospect Pty Ltd. The new chairman, who will have a casting vote, is the former chairman of Good Prospect Pty Ltd.

After the merger Junior Ltd has 2,700,000 shares on issue as follows:

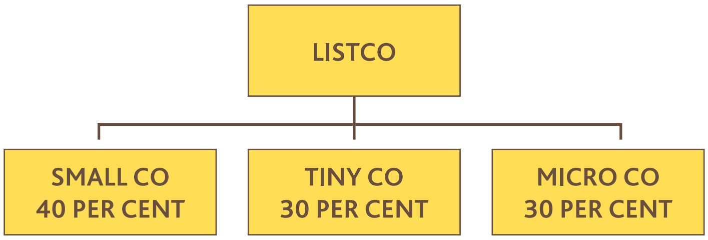
| | SHARES |
|---|---|
| Original share capital | 1,000,000 |
| Merger shares to Good Prospect Pty Ltd shareholders | 1,200,000 |
| | 2,200,000 |
| Additional capital raised | 500,000 |
| Total | 2,700,000 |

The original shareholders of Good Prospect Pty Ltd own 44.4 per cent of the total shares issued (1,200,000 out of a total of 2,700,000 shares) but prior to the additional capital raising, they owned 54.5 per cent of the shares (1,200,000 out of 2,200,000).

In the above example, Good Prospect Pty Ltd is the accounting parent, its assets should not be fair valued, and all comparative information should be that of Good Prospect Pty Ltd.

**Example 3:**
Listco Ltd is established to acquire Small Co Pty Ltd (Small Co), Tiny Co Pty Ltd (Tiny Co) and Micro Co Pty Ltd (Micro Co).

Acquisition is by way of shares. Structure of the group after acquisition is as follows:




Relative net assets and fair value of Small Co, Tiny Co and Micro Co are:

| | NET ASSETS $ | FAIR VALUE $ | GOODWILL $ |
|---|---|---|---|
| Small | 100 | 1,000 | 900 |
| Tiny | 100 | 800 | 700 |
| Micro | 100 | 800 | 700 |
| Total | 300 | 2,600 | 2,300 |

Listco argues that since the shareholders of Small Co have only retained 40 per cent of the group, Listco should be treated as the acquirer and the acquisition accounting should be:

| | $ |
|---|---|
| Goodwill | 2,300 |
| Net assets | 300 |
| Equity | 2,600 |

However, Small Co should be treated as the acquirer and the correct balance sheet is:

| | $ |
|---|---|
| GOODWILL | 1,400 |
| NET ASSETS | 300 |
| EQUITY | 1,700 |

## Fresh start accounting

Errors in applying 'fresh start' accounting can apply both when a company goes for an IPO using a new listing vehicle and where a group inserts an intermediate holding company.

**'Fresh start' - IPO**
Olde Pty Ltd goes for an IPO. For various tax reasons, the IPO is to be via way of New Co Limited. New Co Limited issues 100,000,000 shares immediately prior to the IPO to acquire Olde Pty Ltd.

This is not a business combination and Olde cannot be fair valued. In New Co Limited's financial statements post IPO, comparative information is that of Olde Pty Ltd.

**Restructuring within a group**
Overseas PLC, listed on the London Stock Exchange, holds its two Australian subsidiaries (Subsidiary A and Subsidiary B) through an intermediate holding company in Singapore. Overseas PLC decides to restructure the group and establishes Australia Pty Ltd to acquire subsidiaries A and B by issuing shares. When preparing financial statements for the Australian sub group, Australia Pty Ltd is not the acquirer. An exercise must be performed to determine whether Subsidiary A acquired Subsidiary B or Subsidiary B acquired Subsidiary A.