REPORT OF THE FINANCIAL REPORTING PANEL – SINO STRATEGIC INTERNATIONAL LIMITED

Executive summary

The Australian Securities and Investments Commission (ASIC) has referred to the Financial Reporting Panel (the Panel) the financial report of Sino Strategic International Limited (SSI) with the claim that the company's financial statements for the half-year ended 31 December 2009 were not in compliance with AASB 3 *Business Combinations*.

The 31 December 2009 financial statements of SSI reflected a business combination with China Entertainment Holdings Limited (CEH) that took place in 2005. This transaction was accounted for with SSI as the acquirer of CEH.

The Panel considered three questions in its evaluation of the claim by ASIC:

1. Was this a business combination?
2. Should this transaction have been accounted for by SSI as a reverse acquisition?
3. If there is need for a correction how should it be accounted for?

Based on the documents provided to the Panel and after hearing evidence from both ASIC and SSI, the Panel concluded that:

1. This was a business combination at the time the transaction took place.
2. This should be accounted for as a reverse acquisition in the financial statements of SSI.
3. Accounting corrections relating to prior period errors should be made retrospectively in accordance with AASB 108.42 as discussed in section 4 below.

The reasons for reaching these conclusions are discussed below in section 3.

1. Background

In November 2005, SSI acquired a 100% interest in CEH. Consideration for the acquisition was the issue of SSI shares to Best Winnings – the then parent of CEH. This transaction resulted in Best Winnings gaining a majority stake – 68% - in SSI. Best Winnings also acquired additional shares subsequent to this date resulting in a final interest of 70%.

CEH was established in early 2005, along with its subsidiary Shanghai Kelo Investment Management Limited (SK). From the date of incorporation until November 2005 SK acquired a significant number of Lottery and Keno permits and began operations. At the date of the acquisition the company was earning agency commissions and incurring operating expenses.

2. Process

The Panel received written submissions from both ASIC and SSI with supporting evidence for their views. Both parties also appeared in a hearing before the panel to discuss their written submissions, provide any additional evidence and to answer questions from the panel.

In forming its conclusion, the panel have taken account of all of the evidence provided via this process and considered the requirements of the relevant Australian Accounting Standards.

3. Reasons for conclusions

All references to AASB 3 below relate to the 2004 version of the standard that was applicable for periods beginning on or after 1 January 2005, and therefore applicable in the financial reporting period when the transaction occurred. The effect of subsequent changes in the standard and therefore the impact on the December 2009 financial statements is considered at 3.4 below.

3.1 Was this a business combination?

AASB 3.Appendix A defined a business combination as:

> 'The bringing together of separate entities or businesses into one reporting entity.'

A business was defined in AASB 3.Appendix A as:

> 'An integrated set of activities and assets conducted and managed for the purpose of providing:
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> (a) A return to investors; or
> (b) Lower costs or other economic benefits directly and proportionately to policyholders or participants.
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> A business generally consists of inputs, processes applied to those inputs and resulting outputs that are, or will be, used to generate revenues. If goodwill is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business.'

At the date of acquisition – November 2005 – CEH and SK were operating entities, as they were earning agency commissions from the licenses that they had obtained and had put in operation. These revenues were small reflecting the start-up phase of the operations.

The Horwath valuation report (August 2005) also indicates that it was a business in its start-up phase, which was the basis for selecting an income approach to value the company. While this valuation of CEH and SK was performed as at June 2005, it was on the basis that the operations would begin shortly thereafter.

At the time of the Extraordinary General Meeting on 31 October 2005, this appears to have happened, as the documents state that SK were earning commissions on lottery and keno sales and intended to expand this with other point of sales.

Therefore the evidence provided indicated that at the date of the acquisition – November 2005 – CEH and SK was conducting a business. Based on the valuations obtained and the transaction recorded by SSI, goodwill was identified relating to CEH, which is additional evidence that CEH was a business.

Therefore the bringing together of CEH and SSI was in fact a business combination within the scope of AASB 3.

3.2 Who is the acquirer?

AASB 3.20 and 21 state that:

> 'Although sometimes it may be difficult to identify an acquirer, there are usually indications that one exists. For example:

(a) if the fair value of one of the combining entities is significantly greater than that of the other combining entity, the entity with the greater fair value is likely to be the acquirer;

(b) if the business combination is effected through an exchange of voting ordinary equity instruments for cash or other assets, the entity giving up cash or other assets is likely to be the acquirer; and

(c) if the business combination results in the management of one of the combining entities being able to dominate the selection of the management team of the resulting combined entity, the entity whose management is able so to dominate is likely to be the acquirer.'

> 'In a business combination effected through an exchange of equity interests, the entity that issues the equity interests is normally the acquirer. However, all pertinent facts and circumstances shall be considered to determine which of the combining entities has the power to govern the financial and operating policies of the other entity (or entities) so as to obtain benefits from its (or their) activities. In some business combinations, commonly referred to as reverse acquisitions, the acquirer is the entity whose equity interests have been acquired and the issuing entity is the acquiree.'

The combination of SSI and CEH was effected through an exchange of equity interests, hence in accordance with paragraph 21, all pertinent facts and circumstances need to be considered to determine if SSI was the acquirer, or whether it was the acquiree in the transaction, given that the issue of shares resulted in a change in the majority ownership of SSI.

AASB 3.21 goes on further to state:

> 'This might be the case when, for example, a private entity arranges to have itself 'acquired' by a smaller public entity as a means of obtaining a stock exchange listing. Although legally the issuing public entity is regarded as the parent and the private entity is regarded as the subsidiary, the legal subsidiary is the acquirer if it has the power to govern the financial and operating policies of the legal parent so as to obtain benefits from its activities. Commonly the acquirer is the larger entity; however, the facts and circumstances surrounding the combination sometimes indicate that a smaller entity acquires a larger entity.'

Together these paragraphs indicate that the following needs to be assessed:

1. Who has the power to govern the financial and operating policies of the entities, which includes an assessment of who dominates the selection of the management team?
2. Which was the larger entity?

3.2.1 Who has the power to govern the financial and operating policies?

The transaction resulted in Best Winnings gaining a majority ownership (68%) in SSI. In accordance with AASB3.19 this is prima facie evidence that Best Winnings gained control of SSI and therefore the combined group. AASB 3.19 states:

> 'A combining entity shall be presumed to have obtained control of another combining entity when it acquires more than one-half of that other entity's voting rights, unless it can be demonstrated that such ownership does not constitute control.'

Further evidence is provided in the Howarth valuation report (August 2005) that a control premium was included in the price per share that was assigned to the shares issued by SSI to Best Winnings, indicating that Best Winnings was taking a controlling stake – not just a majority stake. While SSI was also considered to have paid a control premium for CEH, this is of no consequence in considering whether or not Best Winnings was the acquirer.

When we consider who the management of the combined business is, factors that point to Best Winnings being the dominant party are:

- The chairperson of the Board of the combined entity was the majority owner of Best Winnings.
- 3 out of the 8 directors were appointed to represent Best Winnings interest. (The remaining additional 2 directors were independently appointed by both Best Winnings and SSI). However given Best Winnings' majority ownership and appointment of the chairperson, they had the capacity (through their 68% shareholding) to change this ratio and to change the makeup of the Board and management at will. It appears that they elected only to have a minority of Board members because they wanted access to the expertise of SSI management.

In assessing who had the power to govern the operations, it is not necessarily relevant how the Board was composed, but rather who had the capacity to make up the Board and determine the composition of the Board.

3.2.2 Which is the larger entity?

The Howarth valuation report (August 2005) indicates that CEH and SK had a larger fair value than SSI. Therefore CEH was apparently the larger of the two entities.

3.3 Does the conclusion regarding Best Winnings affect the consolidation for a sub-set of the group?

When looking at the consolidated financial statements of a subset of entities of a larger group, the question arises as to whether this same view still prevails. In this case, SSI and its subsidiaries is a sub-set of the larger group in which Best Winnings is the Parent.

The evidence indicates that SSI acquired CEH and its subsidiary SK. SSI was the party giving up consideration, and the Howarth valuation report (August 2005) clearly identified that SSI paid a control premium over the value of the CEH group.

However, this acquisition cannot be viewed in isolation of the bigger change in control that took place at SSI. Best Winnings, as the parent of CEH have never given up control of CEH and its subsidiaries, as they continued to maintain their control through SSI. It is, therefore, inconsistent with that fact to argue that Sino is the acquirer and is obtaining control of CEH. As the controlling party, the way in which the transaction was structured is at Best Winnings' discretion. SSI indicated that they approached the management of Best Winnings in relation to this transaction, however this on its own does not indicate that SSI directed the structure of the transaction. The essence of the transaction is that Best Winnings expanded its group to gain control of SSI. As such, this change cannot be ignored at the sub-level when SSI is preparing its consolidated financial statements.

The aim of 'reverse acquisition' accounting is that the identification of the acquirer – and therefore, the way in which the combination is presented – should reflect the substance of the transaction and not be affected by the legal form by which the transaction is consummated. Therefore it is expected that the same outcome would arise whether Sino is the legal parent or whether CEH is the legal parent.

Best Winning – clearly the acquirer at the larger group level – could have structured the transaction differently by having CEH issue new shares to acquire 100% of the shares held by the Sino shareholders leaving former Sino shareholders with 32% of the expanded CEH: Sino group and Best Winning with 68%. The resulting group and ownership structure would be identical in economic terms to the transaction as it is actually structured. If the transaction had been structured in this manner, we do not see any basis for concluding at the sub-group level that Sino has in substance acquired CEH through a reverse takeover.

In the accounts of SSI, CEH is considered to be the parent as representative of Best Winnings.

3.4 Relevance to the 2009 financial statements

AASB 3 was revised with an effective date to apply to reporting periods beginning on or after 1 July 2009. The transition provisions of this revised standard are set out in AASB 3.65 and state:

> 'Assets and liabilities that arose from business combinations whose acquisition dates preceded the application of this Standard shall not be adjusted upon application of this Standard.'

This indicates that provided the previous version of IFRS 3 was properly implemented, no adjustment is necessary to apply the revised version of IFRS 3 retrospectively.

4. Accounting correction

SSI are required to account for a prior period error in their next set of financial statements as set out in AASB 108.42 and .43:

> 'Subject to paragraph 43, an entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:
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> (a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or
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> (b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.
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> A prior period error shall be corrected by retrospective restatement except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error.'

Therefore the financial statements of SSI must reflect a retrospective restatement as at the beginning of the comparative period. In accordance with AASB 101.10(f), a balance sheet for the opening comparative period will also be required.

AASB 3.B7 states that:

> 'Consolidated financial statements prepared following a reverse acquisition shall be issued under the name of the legal parent, but described in the notes as a continuation of the financial statements of the legal subsidiary (i.e. the acquirer for accounting purposes). Because the consolidated financial statements represent a continuation of the financial statements of the legal subsidiary):
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> (a) The assets and liabilities of the legal subsidiary shall be recognised and measured in those consolidated financial statements at their pre-combination carrying amounts.

(b) The retained earnings and other equity balances recognised in those consolidated financial statements shall be the retained earnings and other equity balances of the legal subsidiary immediately before the business combination.

(c) The amount recognised as issued equity instruments in those consolidated financial statements shall be determined by adding to the issued equity of the legal subsidiary immediately before the business combination to the cost of the combination determined as described in paragraphs B4-B6. However, the equity structure appearing in those consolidated financial statements (i.e. the number of equity instruments issued) shall reflect the equity structure of the legal parent, including the equity instruments issued by the legal parent to effect the combination.

(d) Comparative information presented in those consolidated financial statement shall be that of the legal subsidiary.'

Therefore in the consolidated financial statements of SSI, the following balances are required to be corrected in the opening balance of the comparative period:

- the balance of goodwill – to reflect goodwill relating to SSI rather than CEH.
- the intangible assets – to reverse the effects of the fair value adjustments to CEH licenses and consider the fair value of any licenses held by SSI in November 2005, including any unrecognised licenses that were held at that date.
- Other SSI assets and liabilities – to consider if there should have been a fair value adjustment to SSI assets and liabilities in November 2005.

To determine the adjustment to goodwill, the cost of acquisition must be determined in accordance with AASB3.B5 and .B6:

> 'In a reverse acquisition, the cost of the business combination is deemed to have been incurred by the legal subsidiary (i.e. the acquirer for accounting purposes) in the form of equity instruments issued to the owners of the legal parent (i.e. the acquire for accounting purposes). If the published price of the equity instruments of the legal subsidiary is used to determine the cost of the combination, a calculation shall be made to determine the number of equity instruments the legal subsidiary would have had to issue to provide the same percentage ownership interest of the combined entity to the owners of the legal parent as they have in the combined entity as a result of the reverse acquisition. The fair value of the number of equity instruments so calculated shall be used as the cost of the combination.
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> If the fair value of the equity instruments of the legal subsidiary is not otherwise clearly evident, the total fair value of all the issued equity instruments of the legal parent before the business combination shall be used as the basis for determining the cost of the combination.'

This means determining the number of shares that CEH would have had to issue to provide the existing owners of SSI with a 39% interest in the combined entity (the subsequent increase in holding by Best Winnings is not considered part of the acquisition for this discussion – further analysis by Best Winnings will need to be undertaken to consider if this is the case, or whether it was a key element of the acquisition). The shares of CEH are not listed on an exchange, however, the Howarth valuation report (August 2005) and the draft BDO report contain information that is relevant to determine what the fair value of the shares of CEH are. It is not the intention of this report to indicate what the fair value is.

Determining the fair value of the assets and liabilities of SSI, including any unrecognised licenses should exclude the use of hindsight. That is, the valuations must reflect the facts known at the date of the acquisition and circumstances as at that date. The Howarth valuation report (August 2005) provides an estimate of the value of SSI, which prima facie indicates that goodwill is present, however does not go on to identify the value of the licenses. Further investigation will need to be undertaken by SSI and Best Winnings to determine the fair values of these other assets.

AASB 108.52 and .53 states:

> 'Retrospectively applying a new accounting policy or correcting a prior period error requires distinguishing information that
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> (a) provides evidence of circumstances that existed on the date(s) as at which the transaction, other event or condition occurred, and
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> (b) would have been available when the financial statements for that prior period were authorised for issue
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> from other information. For some types of estimates (eg an estimate of fair value not based on an observable price or observable inputs), it is impracticable to distinguish these types of information. When retrospective application or retrospective restatement would require making a significant estimate for which it is impossible to distinguish these two types of information, it is impracticable to apply the new accounting policy or correct the prior period error retrospectively.
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> Hindsight should not be used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period.....The fact that significant estimates are frequently required when amending comparative information presented for prior periods does not prevent reliable adjustment or correction of the comparative information.'

This will result in an adjustment to the equity reported by SSI, with any remaining difference between the value of the assets, goodwill and cost of the acquisition is to be booked in opening retained earnings.

As these adjustments are applied retrospectively, the asset values recognised above must then be adjusted for:

- depreciation and amortisation of the assets of SSI that are restated, from November 2005 until the opening comparative period, in accordance with AASB 116 and 138;
- impairment charges needed for the assets of SSI that are restated, from November 2005 until the opening comparative period, in accordance with AASB 136; and
- impairment charges for goodwill relating to SSI from at least the first complete annual reporting period (30 June 2007) until the opening comparative period, in accordance with AASB 136.