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(NSW) Pty Ltd ABN 32

Chartered Accountants

11 April 2003

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Annette Kimmitt
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International Accounting Standards Board
Email: commentletters@iasb.org.uk

Dear Ms Kimmitt

INTERNATIONAL ACCOUNTING STANDARDS BOARD
ED3 BUSINESS COMBINATIONS

I make the following comments in relation to ED3.

Reverse Acquisitions

In my view ED3 includes a completely wrong approach in relation to reverse acquisitions. My reasons for this are set out below. In giving my reasons please assume that I am commenting on the example included the Draft Illustrative Examples on ED3 Business Combinations at page 9.

Who Owns Whom?

ED3 stipulates that Entity B controls Entity A.

This is factually incorrect. As Entity B owns no shares in Entity A, it has no voting rights and no control of anything done by Entity A.

It is the individual shareholders in Entity B who might, as a group, control Entity A.

If those shareholders are diverse, or if there is one Entity A shareholder who votes 40%, it might be that the "old" shareholders of Entity A still control Entity A, and therefore Entity B.

The approach adopted by ED3 does not consider what might happen if some of the shareholders of A also hold shares in B prior to the combination.

Also, Entity B might have 60 different shareholders, each of whom now owns, and therefore votes, 1% of Entity A. ED3 has an implicit assumption that these shareholders will together control Entity A. I don't believe that this implicit assumption is valid.

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Minority Interest

The example given in the Draft Illustrative Examples includes an example of minority interest.

Firstly, I consider that the Australia approach of "outside equity interest" is infinitely preferable to "minority interest" in a control framework.

Further, the example given assumes that the only outside equity shareholders in the Combined Entity are the shareholders of B who do not also own shares in A. This is not correct. There are also 100 ordinary shares of Entity A that are not owned by the former Entity B shareholders.

I also do not understand how an Entity B shareholder who does not swap his shares for Entity A shares is considered to be a minority shareholder, given that the ED3 treats Entity B as the parent entity.

Who is Parent?

The definition of a Parent Entity in ED3 indicates that in the reverse acquisition example, Entity B is the parent.

In my view Entity B does not control Entity A and therefore Entity B cannot be Entity A's parent.

Contributed Equity

The contributed equity shown in the example consolidated balance sheet of 2,200 includes:

(a) 1,600 of issued equity of Entity A, and
(b) 600 of Entity B.

Prior to ED3, the owners equity included equity issued to shareholders of the owner. ED3 shows owners equity as issued to both the parent entity and to some of the shareholders of a subsidiary entity, ie those shareholders who accepted the share swap.

This is a mixed concept and in my view is conceptually incorrect.

Also, ED3 does not explain what to do about any of the holders of the 300 Entity A shares who, by chance, also held shares in Entity B prior to the combination.

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Dilution

The example in ED3 notes that prior to the combination the fair value of each ordinary share of B is 40. I assume that this is prior to the combination, and the share swap.

If my assumption is correct, the example is incorrect by not taking into account the dilution to the value of each ordinary share of B.

Market Price of Entity A

The example in the ED3 does not explain why the fair value of Entity B's shares is used, and the quoted market price of Entity A's shares is ignored.

Change to Group Equity

If I assume that Entity A is the parent entity, and we don't follow the reverse acquisition method proposed by ED3, at 30 September 20X1 the consolidated owners equity is 3,500, including outside equity interest of 800. This is 100 less than that shown in the example.

I don't understand why the owners equity changes as a result of a different accounting method.

Pre-acquisition Profits

The previous concept of pre-acquisition profits was that the combined group cannot "buy" profits, and can only report as profits any profits that come from decisions made by the directors of the controlling entity.

The board meeting of Entity B will be controlled by directors appointed by Entity A. It is therefore Entity A that controls the operating policies of Entity B, and it is Entity B's profits that should be treated as pre-acquisition.

I will be happy to discuss any of these issues with you.

Yours faithfully

D K Swindells
Director