



30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

**International
Accounting Standards
Board**

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: November 2008, London

Project: Consolidation

Subject: Consolidation: Sweep Issues—Options, warrants and convertible instruments (Agenda paper 16A)

Introduction

- 1 In September 2006 the Board tentatively decided in its conceptual framework project that in the case of an option over an asset, the entity's asset is its present right to the counterparty's contractual promise to deliver the subject matter of the option if it is exercised, rather than a right to the subject matter itself. This means that an option holder would recognise in its financial statements the option, not the assets that are subject to that option. The Board decided also that when an option holder has sufficient options that, if exercised, would place it in control of another entity that is not sufficient, in itself, to establish that the option holder has control of the other entity. The consolidation team incorporated this decision into previous staff drafts of the consolidation exposure draft.
- 2 At the October meeting, a Board member expressed concerns about the inconsistency between the way we have been thinking about options and the way we think about a passive majority vote holder.

- 3 The Board and the staff agree that a party that holds more than half of the shares in an entity controls that entity whether or not that party has exercised its votes. The fact that the party is able to exercise the votes means that it has the ability to control the governing body of the entity. We seem to have reached a different conclusion for options, warrants and convertibles. A party that has an option to obtain a majority of the voting interests in an entity for little or only notional consideration does not, on the face of it, control that entity.
- 4 In the first case the party has the voting rights but we seem to accept that the party need not actually vote to control the entity. We do not require the party to wait until an annual meeting (or a meeting that the party calls) at which it exercises the votes before that party is deemed to have obtained control. If it is okay to ‘ignore’ the fact that an actual vote has not taken place why do we insist that an option holder must have exercised the option before the option holder has control? The inconsistency is highlighted in the case in which little or no consideration is required to be transferred by the option holder. Why do we ignore one step but not two?
- 5 We have also agreed that a parent can control a subsidiary by having the right to remove, without cause, another party that is empowered to direct the activities of the subsidiary. An option or convertible right would seem to give this power to an option holder because a presently exercisable option gives the holder the ability to remove the current holder of the voting interests.
- 6 Therefore, the Board has asked the staff to revisit the treatment of options in the staff draft. This agenda paper analyses:
- a whether and, if so, under which facts and circumstances potential voting rights are sufficient for a reporting entity to have control of another entity; and
 - b whether a reporting entity should assess potential voting rights continuously when determining whether it controls another entity.

Requirements in IAS 27

- 7 A reporting entity may own options, convertible instruments or other instruments that have the potential, if exercised, to give the reporting entity voting rights or reduce

another party's voting rights in another entity. IAS 27 refers to those instruments as potential voting rights. According to that standard, the existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing control. IAS 27 clarifies that in assessing whether potential voting rights contribute to control, the entity examines all facts and circumstances that affect potential voting rights, except the intention of management and the financial ability to exercise or convert such rights.

Conceptual Framework Discussion

- 8 The conceptual framework team has analysed those requirements as part of its work on the reporting entity discussion paper. The staff looked at an example, where Company A holds options over 100 percent of the ordinary shares in Company X, which are currently held by Company B. At that time the staff argued that Company A does not presently control either the shares in Company X or Company X itself. Company A may have the ability to take control, but does not at *present* control Company X. The staff noted that if holding an option were to give the option holder control of the underlying asset, the reporting entity would treat the exercise of the option as inconsequential.
- 9 Having argued that holding an option does not give the holder present control over another entity, the staff did not rule out the possibility that there might be situations, in which the holding of options, taken in conjunction with other facts and circumstances, might lead to the conclusion that the option holder has present control over the other entity. For example, suppose that Company A holds 40 percent of the voting shares in Company X and holds an option to acquire another 15 percent. Also suppose that, under the option contract, the present holder of the 15 percent must exercise its voting rights as directed by Company A. This means, that although Company A has not yet acquired all the rights associated with those shares it has, in effect, acquired the voting rights associated with those shares and therefore controls Company X.
- 10 Finally, the staff acknowledged that the conceptual framework discussion might differ from Board decisions at standards-level. The staff argued that, for example, practical considerations might require the Board to take a different approach to an issue at a standards-level than is taken at the concepts level.

Staff Analysis

- 11 The definition of control of an entity requires the parent to have the power to direct the activities of the entity to generate returns for the parent. When the activities of an entity are directed by means of strategic operating and financing policies, the body that determines those policies acts as an agent for the shareholders. The shareholders ultimately have the power to direct the activities by having the ability to appoint the members of the governing body.
- 12 When considering potential voting rights, the question is whether the holder of the voting interests is itself an agent of the option holder. If this is the case, the option holder is the controlling party.
- 13 There are two conflicting views held by the staff. We agree that options must be assessed on the basis of power and returns. However, some of us think that having an option for which it is beneficial for the holder to exercise is, of itself, power. We refer to this as the **economic power** view. The rest of us think that for an option to give the holder the power to direct the activities of the underlying entity the option holder will need to have related rights. We refer to this as the **related rights** view.

Economic power

- 14 The holder of options over shares that would benefit from exercising those options is in a position of strength over the holder of the shares. This because the option holder can take those shares away from the current holder, and has an economic incentive to do so. We argue that because they are in this position of strength the option holder is able to direct the holder of the shares to act in accordance with the option holder's explicit, or implicit, directions.
- 15 To have economic power, exercising the options must be beneficial to the holder. An option does not need to be in the money to be beneficial to the option holder. An out of the money option can be beneficial to the holder if exercising the option gives the holder access to returns (such as through synergies) that are not available to other parties.

- 16 Assuming that exercising an option is beneficial, the next question is whether the option holder is **able** to access those benefits by exercising the option. An option holder will be able to exercise an option in virtually all circumstances in which the option is currently exercisable for little or no cash or other consideration. There is no significant obstacle, financial or otherwise, to prevent the option holder from obtaining the underlying shares.
- 17 Many constituents believe that, if an option holder does not have the means to exercise the options the option holder is not in a position of strength over the holder of the shares. Previous staff have argued that an option holder could always obtain the financing to exercise options that are in the money and that, therefore, the financial ability criterion would always be met. Many constituents argue that this view is too simplistic. Those constituents point to the current financial crisis to illustrate that an option holder might not be able to obtain the funding to exercise options and believe that the financial ability of the holder of the options right should be one of the factors to be considered when assessing those rights. Those of us who support the economic power view agree with these constituents but note that this view is contrary to the current requirements in IAS 27.
- 18 Proponents of the economic power view propose that the ED state that a reporting entity controls an entity over which it has options if:
- a the options are currently exercisable; and
 - b the exercise of the options is beneficial for the option holder.

Related rights

- 19 Those of us that support the related rights view think that when a reporting entity writes or acquires potential voting rights, there is a purpose in doing so. The options might be designed for speculative purposes, for protective purposes or to give the holder the ability to direct the activities of the entity to which they relate. The terms and conditions attached to the options will reflect that intention.
- 20 For example, a reporting entity might acquire options to purchase shares in an entity in addition to investing in that entity (either by acquiring shares or giving a loan to that

entity). If the options are designed to give the holder the ability to direct the activities of an entity there are likely to be related rights such as the right to appoint senior staff, approval rights over budgets or veto rights over expenditure and so on.

- 21 In contrast, if a reporting entity with an investment in another entity acquires options for protective purposes, the terms of the options might be such that they can only be exercised under particular conditions, or for a price that would only become advantageous for the holder if its investment was at risk.
- 22 Proponents of the related rights view think that the exposure draft should include guidance that states that the holding of an option can give the holder the ability to direct the activities of an entity, and that a reporting entity considers the purpose of the potential voting rights *at the time that the reporting entity writes or purchases those potential voting rights*.
- 23 We also note that if an option is exercisable at a price that equals the fair value of the returns from that entity the option holder does not get a return from the option until that option is exercised. It is only once the option holder has obtained the shares that they get access to the returns. We also think that if the exercise price is trivial, and the options are currently exercisable, the option holder should be deemed to hold the underlying shares. We reach this conclusion on the basis that pricing an option with a trivial exercise price is evidence that the option is designed to give the holder control.

Currently exercisable

- 24 Paragraph 14 of IAS 27 states that ‘potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event’.
- 25 Those of us who support the economic power view think that an option can be ‘currently exercisable’ even if it cannot be exercised today, provided that it is valuable and the date of exercise is sufficiently close to the current date that the option holder is able to use the option to direct the activities of the entity. This view differs from the current guidance in IAS 27 regarding the meaning of currently exercisable. We would therefore recommend adding an illustrative example to the exposure draft clarifying that “current” does not have to mean “today”.

26 Those of us who support the related rights view think that it is the related rights that give the holder the ability to direct the activities. It should not matter if the party can exercise the option today as long as the holder has the current power to direct the entity.

Continuous assessment

27 The draft ED states that assessing whether a reporting entity has power sufficient to control another entity is a continuous process. Therefore, a reporting entity holding potential voting rights would continually assess whether the holding of those potential voting rights gives it the ability to direct the activities of the entity to which the voting rights relate.

28 There is no disagreement amongst the staff that assessment of control is continuous. However, those of us that support the economic power view would assess the value of the option to the holder. A change in the value of that option could cause a change in control. This raises the concern that fluctuations in the market price of the shares underlying the options might lead to the conclusion that exercise of the options would be beneficial for the reporting entity in one year, but not in the following year and vice-versa. As a consequence, a reporting entity might consolidate an entity for a part or parts of a reporting period because the change in market condition is a change in **power** over the activities of an entity.

29 These staff recognise the concern regarding the potential to move in and out of control with every change in market conditions. However, in their view it is not clear how common these situations will be—ie in which an entity would switch in and out of being controlled by a reporting entity. They think that the assessment of options requires consideration of all facts and circumstances and suspect that it would be rare that mere changes in market conditions would trigger consolidation or deconsolidation on a repeated basis.

30 Proponents of the related rights view think that control does not change simply because of a change in market conditions. Rather, a change in the market conditions might cause the option holder to take steps that change its rights to the extent that the option holder obtains control of the underlying entity. The obvious example is that the option holder exercises the options. But there might be circumstances in which the

change in market conditions gives the option holder the ability to, say, enter into an agreement with the option counterparty in which the counterparty agrees to exercise its votes only after consulting with the option holder. The difference between the related rights view and the economic power view is that, in this scenario, when the option was issued it was not designed or intended to give the option holder the ability to direct the activities of the underlying entity. The change in market conditions has, in effect, given the option holder the ability to renegotiate its rights. In contrast, the economic power view is indifferent about the initial intention of the parties and bases control on whether the option gives the holder economic power.

Consistency with a passive shareholding

- 31 Are these views consistent with the passive investment scenario introduced at the beginning of this paper—ie an investor that has 60 per cent of the voting interests in an entity but has yet to exercise those votes controls that entity .
- 32 Those of us who support the economic power view argue that the option holder is like the passive investor. The fact that exercising the option would be beneficial gives the holder power over the option counterparty and that it is not necessary to exercise the option to exercise that power.
- 33 Those of us who support the related rights view think that this view is consistent with the ‘passive investor’ scenario, not because the option holders have control but because the options by themselves do not give the holder the right to vote. It is the related rights that give the option holder the power and focusing on those rights differentiates an option holder from a passive investor.
- 34 The proponents of the related rights view also note that the governing body is acting as an agent of the passive shareholder, even though those shareholders have not exercised their right to vote. The governing body is not an agent of the option holders. In fact they have no relationship with the option holders. It is the relationship between the option holders and the holders of the voting rights that is important. A governing body might not even be aware of the existence of the option holders.

Question for the Board

- 35 **Does the Board agree with the economic power view or the related rights view, or neither?**

Appendix: Consistency of the staff recommendation with other projects

Leases

36 In July 2008 the Board discussed lease contracts that give the lessee an option to extend the lease for an additional period or an option to terminate the lease early. The Board tentatively decided that the lessee should not recognise these options as separate assets. Instead, the assets and liabilities recognised by the lessee should be based upon the lease term. The Board also discussed some of the factors that affect whether a lessee will exercise an option to extend or terminate a lease. The Board tentatively decided that contractual, non-contractual and business factors should be considered when determining the lease term. At the November Board meeting the leases project team will recommend reassessment of the lease term at each reporting date.

Derecognition

37 One of the criteria for derecognition of financial assets that are currently discussed in the derecognition project is the practical ability of the transferee to transfer the financial asset in its entirety to a third party for its own benefit. At the October Board meeting the derecognition team argued that if the transferor holds a call option to repurchase a transferred financial asset that is not readily obtainable, the transferee is not free to transfer the asset without restrictions.

38 However, if the asset is readily obtainable, the call option that a transferor holds will not restrict the transferee from transferring the purchased financial asset to a third party. This is because the transferee could easily obtain a replacement asset if it had to perform under the call.

39 The derecognition team has developed two possible approaches to deal with circumstances, in which the transferee does not have the practical ability to transfer a financial asset in its entirety to a third party for its own benefit. Approach 1 investigates whether the transferee has presently other access to all or some of the cash flows of the transferred financial asset for its own benefit. According to that approach the parties involved in the transfer of the asset look at the contractual terms of the option. For example, an option that is neither deeply in or deeply out of the money or an option with an exercise price equal to the fair value of the underlying financial asset

implies that the transferee has presently other access to all or some of the cash flows of the transferred financial asset for its own benefit. In contrast, a nominal exercise price of the options means that the transferor has retained access to effectively all of the cash flows of the transferred financial asset for its own benefit.

- 40 Approach 2 concludes that if a transferee does not have the practical ability to transfer a financial asset it purchased from a transferor to a third party, control has not passed to the transferee. Accordingly, unless a call option is so deeply out of the money at the time of transfer that it is unlikely that the transferor will exercise it, such a call option would preclude derecognition of the related financial asset if that asset were not readily obtainable.
- 41 For purposes of applying the ‘practical ability to transfer’ test, the derecognition team believes the assessment requires judgment. Some factors to consider are:
- i The terms of the transfer (contractual) arrangement
 - ii Other contracts or arrangements entered into in relation to the transfer
 - iii The nature of the asset
 - iv The market for the asset
 - v The transferee’s ability to obtain the full economic benefits
 - vi Economic constraints.
- 42 A transfer that does not qualify for derecognition because the transferee is deemed not to have the practical ability to transfer the asset to a third party will qualify for derecognition if conditions subsequently change so as to give the transferee that ability. Exceptions to this principle are the following:
- i Subsequent events that change the probability of an option being exercised (other than the exercise or expiration of the option itself) generally would not result in a change to the assets and liabilities recognised and derecognised.

- ii Once a transferor derecognises a financial asset because it judges that the transferee has the practical ability to transfer that asset to a third party, it will not have to re-recognise the asset if conditions subsequently change resulting in the transferee no longer having the practical ability to transfer the asset.