



Project	<b>Consolidation</b>
Topic	<b>Power to direct the activities of an entity (Part I) - Power without a majority of the voting rights -</b>

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## Introduction

1. Paragraph 4 of ED 10 *Consolidated Financial Statements* (the ED) defines control as the power to direct the activities of another entity to generate returns for the reporting entity. The ED does not define “power to direct the activities of another entity” (power), but describes some of its characteristics.
2. Many respondents to the ED and round table participants believed either that the characterisation of power in the ED was unclear or that the characteristics of power had been inconsistently translated into particular requirements in the ED. The purpose of this paper is to analyse respondents’ concerns and to discuss whether and how the proposed requirements should be amended to address those concerns.
3. The staff believes that it will facilitate the discussion if we analyse power on the basis of examples and not abstract concepts. Therefore, this agenda paper and agenda paper 10C investigate, after a brief summary of the requirements in the ED, the application of the power concept to the following situations:
  - (a) Power of a passive majority shareholder
  - (b) Power without a majority of the voting rights
  - (c) Options and convertible instruments (agenda paper 10C)
4. We will discuss power in the context of structured entities at the Board meeting in September 2009.

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## **Power to direct the activities of another entity**

5. The following paragraphs in the ED characterise power:
  - (a) Paragraph 5 states that a parent's power precludes others from controlling its subsidiary.
  - (b) Paragraph 6 states that power need not be absolute and explains that protective rights of other parties do not preclude a parent from controlling a subsidiary.
  - (c) Paragraph 8 states that a reporting entity can possess power to direct the activities of another entity by different means, including by having voting rights, by having options or convertible instruments to obtain voting rights, by means of contractual arrangements, or a combination of these.
  - (d) Paragraph 9 states that a reporting entity can have power by having an agent act on its behalf.
  - (e) Paragraph 22 states that a reporting entity has the power to direct the activities of another entity if it can determine that other entity's strategic operating and financing policies.
  - (f) Paragraph 8 clarifies that a reporting entity need not have exercised its power to direct the activities of an entity to control that entity.
6. In addition, we think that the following two aspects of power, embedded within the ED, were not articulated clearly enough.

### ***Power must be current***

7. We believe that to have power the reporting entity must be able to direct the activities of another entity today (we will explore this concept further when the Board deliberates power in the context of structured entities and the predetermination of policies). However, it does not mean that the mechanism that provides a reporting entity with power could not have timing delays.

8. For example, the ED assumes that a majority shareholder in an entity has current power even though it might have to wait for the next shareholder meeting to enforce its will. The ED assumes that a reporting entity has current power as soon as a mechanism is in place that enables it to direct the activities of another entity today.

***Power is assessed on the basis of the current set of facts and circumstances***

9. We believe that, when assessing power, it should not matter that a reporting entity could lose the power to direct the activities of another entity if subsequently a change in facts and circumstances occurs. That change might occur because, for example, another party acquires more than half of the voting rights of the entity. However, it might also occur because of changes in facts and circumstances that do not involve changes in the holdings of voting rights.
10. For example, according to the ED, a reporting entity can have the power to direct the activities of another entity even though it has less than a majority of the voting rights and the other shareholders could subsequently organise themselves to block the decisions of the reporting entity. In this scenario, the reporting entity has power if it can assume that the other shareholders are not currently in a position in which they could easily organise themselves to prevent the reporting entity from directing the activities of the other entity. If this assessment changes subsequently, for example, because some or all of the other shareholders agree to vote in a coordinated way, the reporting entity will no longer meet the power element of the control definition.
11. Many respondents disagreed with the proposed requirements but not because they disagreed with the characterisation of power. Rather, they either disagreed with how the characteristics of power had been applied or believed that they had not been applied consistently in the ED. The following sections of this paper and agenda paper 10C will, therefore, focus on the application of power to three specific situations—a passive majority shareholder, the holder of less than half of the voting rights and the holder of options.

1. Does the Board agree with the following characterisation of power?
  - power is assessed on the basis of current facts and circumstances
  - power precludes others from controlling the entity
  - power need not be absolute
  - power need not be exercised
  - power is current
  - a reporting entity can possess power by different means
  
2. Are Board members aware of additional characteristics of power that should be included in the final standard?

### **Power of a passive majority shareholder**

12. Assume that investor A owns 60% of the voting rights in Entity B. C founded Entity B and owns 40% of the voting rights. The activities of Entity B are directed through voting rights. Because of C's knowledge of Entity B's activities, A chooses not to use its voting rights and allows C to direct the activities of Entity B. However, A is free to request at any time a shareholder meeting to appoint new management of Entity B.
  
13. The ED describes in paragraphs 23 and 24 that a party that holds more than half of the voting rights in an entity that is directed through voting rights meets the power element of the control definition (in the absence of other factors). Paragraph 8 states that the passive majority shareholder need not have exercised its power to control that entity. This means that in the example, A controls Entity B, because it has the power to direct the activities of Entity B and can benefit from that power.
  
14. Respondents did not disagree with how the ED analyses power in the context of a passive majority shareholder, but argued that the analysis was inconsistent with the analysis of power in situations in which the reporting entity has less than half of the voting rights or in which the reporting entity has options or convertible instruments.

## Power without a majority of the voting rights

15. According to paragraph 26 of the ED, a reporting entity can have power to direct the activities of another entity even though it holds less than half of the voting rights of that entity. The reporting entity can have that power by different means:

- (a) An agreement between a reporting entity and other vote holders can give the reporting entity the right to exercise voting rights sufficient to give the reporting entity the power to direct the activities of another entity, even though the reporting entity itself holds voting rights that would not be sufficient to give it power.
- (b) Similarly, other forms of agreement can give the reporting entity the power to direct the activities of another entity, particularly if combined with other rights such as voting rights. For example, a party might be able to direct the activities of an entity by being able to appoint the key personnel of that entity.
- (c) Finally, a reporting entity can meet the power element solely because of its voting rights when compared to those of other shareholders. For example, A might meet the power element because it holds 45% of the voting rights of Entity B and the remaining 55% are dispersed among more than a thousand other shareholders. We believe that, in this example, the other shareholders could not easily organise themselves to prevent A from directing the activities of Entity B.

The appendix to this paper sets out paragraphs 26-28 of the ED—power to direct the activities without a majority of the voting rights.

16. Consistent with the discussion of a passive majority shareholder above, none of the means through which a reporting entity with less than half of the voting rights can have power requires the actual exercise of that power. Many respondents argued that this point was not clearly expressed in the ED. We acknowledge this concern and intend to clarify the wording in the final standard.

17. Respondents generally agreed that a reporting entity can meet the power element of the control definition without having a majority of the voting rights of another entity. However, many respondents believed that this principle should apply only in the scenarios described in paragraphs 15(a) and (b) of this paper and disagreed with the conclusion in paragraph 15(c).
18. Those respondents disagreed with paragraph 15(c) because they believed that the power to direct the activities of another entity implies that other parties must not be able to prevent the reporting entity from exercising its power in any circumstance. They argue that, in the example in paragraph 15(c), A does not meet the power element because all of the other shareholders could vote against A's actions and therefore prevent A from directing the activities of Entity B.
19. We agree with those respondents that a reporting entity does not meet the power element if, on the basis of current facts and circumstances, other parties have the ability to prevent the reporting entity from exercising its power. However, we note that there are different views of how to apply this principle to the example.

***'Contractual rights' view: The holder of less than half of the voting rights cannot have the power to direct the activities of another entity without other agreements***

20. According to the 'contractual rights' view, the position of the other shareholders is similar to that of a passive majority shareholder. The other shareholders allow the reporting entity to direct the activities of the other entity as long as the reporting entity acts according to their will. If the reporting entity should act against the will of those shareholders, they would vote against those actions and prevent the reporting entity from directing the activities of the other entity.
21. Proponents of the 'contractual rights' view emphasise that it does not matter whether the other shareholders are widely dispersed because they would not necessarily need to organise themselves to prevent the reporting entity from directing the activities of the other entity. As soon as the actions of the reporting entity affect the common interests of a sufficiently large number of other shareholders, the unorganised votes of the dispersed shareholders would be sufficient to block the actions of the reporting entity.

22. Therefore, proponents of the ‘contractual rights’ view would eliminate the example in paragraph 28 of the ED (paragraph 28 is reproduced in the Appendix to this paper). Rather, they would clarify that a reporting entity without a majority of the voting rights has the ability to exercise power only if it can enforce its will by means of other agreements (see paragraph 15(a) and (b) of this paper).
23. Those proponents argue that adopting this view would simplify the requirements in the ED because it would avoid the application questions raised by the proposal in paragraph 15(c). In addition, they believe that such an amendment would not significantly change the scope of entities to be consolidated when compared to the ED. In their view, a reporting entity that controls another entity would normally have, in addition to its voting rights, further arrangements in place that guarantee or demonstrate the power to direct the activities of the other entity (for example, some of those arrangements set out as indicators of power in paragraph B9 of the ED).

***‘Dominant shareholder’ view: The holder of less than half of the voting rights can have power to direct the activities of another entity without other agreements***

24. We agree with the ‘dominant shareholder’ view. A reporting entity can have the ability to direct the activities of another entity even though it has neither the majority of the voting rights in that entity nor other agreements in place. In particular, we think that this is the case if the reporting entity:
- (a) has more voting rights than any other party;
  - (b) the reporting entity’s holding of voting rights is significantly bigger than that of any of the other shareholders (this is often the case when the other shareholdings are widely dispersed); and
  - (c) the other shareholders are not in a position in which they could easily organise themselves to prevent the reporting entity from directing the activities of the entity.
25. In this situation, the other shareholders would not usually be able to prevent the reporting entity from directing the activities of the other entity and, as a

consequence, the reporting entity would meet the power element of the control definition. The reasons for this view are explained in following paragraphs.

*Organisation of the other shareholders*

26. We agree with the proponents of the ‘contractual rights’ view that a reporting entity with less than half of the voting rights could not direct the activities of another entity against the will of most or all of the other shareholders. Those shareholders would not need to organise themselves. If the actions of the reporting entity affect their common interest, a sufficient number of dissenting votes of those shareholders would prevent the reporting entity from taking those actions, irrespective of whether the dissenting shareholders had organised themselves.
27. However, we believe that a widely dispersed group of shareholders would usually also have widely dispersed interests. Therefore, we think that very few actions of the reporting entity would be against the will of most or all of the other shareholders, and could therefore be blocked without any active cooperation of those shareholders. We also believe that the smaller the individual voting interests of those shareholders the more likely it is that they would simply sell their shares, rather than vote against the actions of the reporting entity, because they could not expect to block the actions of the reporting entity.
28. Paragraph 6 of the ED states that to control another entity the power of the reporting entity does not need to be absolute. The ED discusses this statement in the context of protective rights. The power of voting rights usually goes beyond that of protective rights.
29. However, we believe that, when there is a shareholder that holds more voting rights than any other shareholder and the remaining shareholders are widely dispersed (such that the largest shareholder has significantly more voting rights than any other shareholder), the voting rights of those other shareholders are effectively approval or veto rights as discussed in paragraph B2 of the ED. In other words, the voting rights protect the interests of those shareholders, but do



not give them the ability to participate in directing of the activities of the entity. They are protective rights.

30. If the actions of the reporting entity cause a group of other shareholders to organise themselves to prevent the reporting entity from directing the activities of the reporting entity, the reporting entity would not meet the power element of the control definition. In our view, this would represent a change in facts and circumstances because of the subsequent cooperation of the other shareholders. As stated in paragraph 10 of this paper, one of the principles underpinning the ED is that, when assessing power, it does not matter whether the reporting entity would lose power if a change in facts and circumstances subsequently occurs.

*Consistency with the treatment of a passive majority shareholder*

31. We think that adopting the ‘dominant shareholder’ view is consistent with the treatment of a passive majority shareholder because that view treats the other shareholders the same as a passive majority shareholder only when they are in a similar position, ie only when they are able to prevent the reporting entity from directing the activities of the other entity and could enforce their own will. This is the case when the other shareholders are organised, or could easily organise themselves, to vote together. In such a situation, this view would conclude that the reporting entity with less than half of the voting rights would *not* meet the power element of the control definition. The other shareholders ‘permit’ the reporting entity to direct the activities of the entity.
32. When the other shareholders are not organised or could not easily organise themselves to vote together, they are not in the same position as a passive majority shareholder. While a passive majority shareholder can at any time choose to prevent another party from directing the activities of the entity, the other shareholders would first need to organise themselves in order to have that ability. The passive majority shareholder ‘permits’ the reporting entity with less than half of the voting rights to direct the activities of an entity.

***Making the 'dominant shareholder' view operational***

33. Many respondents argued that the proposed guidance in the ED is not operational because:

- (a) the ED might require a reporting entity to consolidate another entity because the remaining shareholders are widely dispersed or attendance at shareholder meetings is low, even though it holds only a low percentage of the voting rights of that entity (i.e. 5% or 10%). Respondents believed that, in those circumstances, the reporting entity was unlikely to be in the position to have the power to direct the activities of the other entity. Therefore, some respondents argued that the final standard should include a statement that a reporting entity would have the ability to exercise power only if it holds a high percentage of the voting rights (i.e. 40%). Other respondents suggested that the Board should clarify that the reporting entity must have “significantly” more voting rights than any other shareholder in that entity.
- (b) the ED might require a reporting entity to obtain information about the shareholder structure of another entity, the degree of organisation of other shareholders and their future intentions. Respondents argued that it would be particularly difficult to obtain the information necessary to make such an assessment when the reporting entity holds only a low percentage of the voting interests in another entity.
- (c) the ED might cause repeated changes in the composition of the group because changes in the shareholder structure or attendance at shareholder meetings might trigger the consolidation or deconsolidation of an entity without any change in the voting rights of the reporting entity. Therefore, some respondents suggested that the final standard should clarify that it is not sufficient to have the ability to exercise power temporarily, but that that ability must be sustainable. Other respondents questioned whether the history of the distribution of voting

rights and the attendance rate at past shareholder meetings matters for the assessment of power.

34. Some respondents suggested that, in light of those concerns, the Board should amend the proposal so that a reporting entity without a majority of the voting rights would meet the power element only when it actually directs the activities of another entity, rather than the ability to do so being sufficient to meet power.
35. Respondents argued also that the drafting in the ED was unclear and asked the Board to explain, among others, the meaning of the terms “more voting rights”, “dominant shareholder”, “widely dispersed” and “co-operation”. The staff believes that these issues could be addressed as part of the drafting process.

*Introduce a quantitative threshold*

36. We agree that generally the lower the number of voting rights that a reporting entity holds in another entity, the less likely it is that the reporting entity meets the power element. Similarly, we believe that it is more likely that a reporting entity has power to direct the activities of another entity if it holds significantly more voting rights in that entity than any other shareholder.
37. The reason for those observations is that the fewer voting rights a reporting entity holds or the narrower the margin between the voting rights of the largest shareholder and those held by others, the more likely it becomes that a sufficiently large number of other shareholders disagrees with the actions of the reporting entity and could prevent it from directing the activities of the other entity.
38. Notwithstanding those observations, we believe that the assessment of power should require the consideration of all facts and circumstances and we are reluctant to recommend limiting that analysis by introducing quantitative thresholds.
39. Therefore, we do not recommend that the Board introduces any quantitative thresholds. Rather, we recommend that the Board address respondents’ concerns by adding the following explanations to the final standard:

- (a) the fewer voting rights a reporting entity holds the less likely it is to meet the power element of the control definition.
- (b) the more voting rights a reporting entity has relative to other parties, the more likely it is that the reporting entity meets the power element.
- (c) the fewer the number of parties that would need to act together to be able to exercise more votes than the reporting entity, the less likely it is that the reporting entity has the power to direct the activities of the entity.

*Availability of the information necessary to comply with the proposed requirement*

- 40. In most cases, we believe that the reporting entity will be able to obtain the information necessary to assess whether a reporting entity with less than half of the voting rights meets the power element. In our view, the reporting entity will generally know whether its investment in another entity is sufficient to enable it to direct the activities of that entity.
- 41. We believe that many respondents expressed concerns that a reporting entity might not be able to obtain the information necessary to comply with the proposed requirement because they were concerned about the application of the requirement to situations in which a reporting entity holds a low percentage of the voting rights of another entity. Therefore, we believe that the suggested clarifications in paragraph 39 would also address some of the respondents' concerns about the availability of the information necessary to comply with the requirement.

*Repeated changes in the composition of the group*

- 42. Some respondents were concerned that the proposals in the ED would result in frequent changes to the assessment of power of a reporting entity with less than half of the voting rights and, therefore, in frequent changes to the composition of the group. Those respondents expressed concerns that this consequence would bear high costs for preparers and have a negative effect on the comparability of the information provided to users.

43. Respondents argued that a reporting entity would have the power to direct the activities of another entity only if that power could not be taken away the next moment. Therefore, they suggested that the Board should clarify in the final standard that a reporting entity would only have power to direct the activities of another entity, when its power is sustainable. In addition, some respondents asked the Board to add an explicit statement to the standard that the history of past shareholder meetings is an important indicator for the assessment of power.
44. We understand respondents' concerns about the risk that the proposal might cause frequent changes in the composition of the group. However, we believe that including a sustainability requirement in the assessment of power would create an inconsistency within the consolidation standard.
45. When the Board issued IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, it removed the exemption for subsidiaries that are held on a temporary basis (temporary control) from IAS 27. Therefore, a reporting entity must consolidate all entities that do not meet the criteria to be classified as held for sale in accordance with IFRS 5, regardless of how long the reporting entity expects to have control over those entities. A sustainability requirement would introduce an exception to this principle for a particular set of entities (ie those entities that are controlled by a reporting entity with less than half of the voting rights).
46. We believe that in practice the clarifications proposed in paragraph 39 of this paper go some way towards addressing those concerns without creating inconsistency in the standard.

*Ability to vs. actual exercise of power*

47. We do not believe that the Board should make an exception for reporting entities with less than half of the voting rights from the principle in paragraph 8 of the ED that a reporting entity need not have exercised power to direct the activities of an entity to control that entity. We disagree with such an exception because it would result in a reporting entity not consolidating entities even though it has the ability to direct the activities of those entities. It would also be inconsistent with the treatment of a passive majority shareholder.

*Staff recommendation*

48. The staff recommends that the Board affirms the ‘dominant shareholder’ view, which was incorporated in paragraph 27 of the ED.
49. In the light of respondents’ concerns, we recommend adding the following explanations to the final standard or application guidance:
- (a) the fewer voting rights a reporting entity holds the less likely it is to meet the power element of the control definition.
  - (b) the more voting rights a reporting entity has relative to other parties, the more likely it is that the reporting entity meets the power element.
  - (c) the fewer the number of parties that would need to act together to be able to exercise more votes than the reporting entity, the less likely it is that the reporting entity has the power to direct the activities of the entity.
50. We intend developing for the final standard some illustrative examples that would help readers understand better the concepts underpinning the assessment of power of a reporting entity without a majority of the voting rights.

**Questions for the Board**

3. Does the Board agree that a reporting entity with less than half of the voting rights can have power to direct the activities of another entity solely because of its voting rights relative to those of other shareholders (the ‘dominant shareholder’ view)? If not, what do you propose and why?

4. Does the Board agree with the staff recommendation to add the explanations set out in paragraph 49 of this paper in the final standard or application guidance? If not, what do you propose and why?

5. Are there other criteria or guidance that the Board would like integrated into the assessment of power when a reporting entity holds less than half of the voting rights (and in the absence of other agreements)?

## Appendix – Extracts from the ED

### Power to direct activities without a majority of the voting rights

- 26 A reporting entity can have the power to direct the activities of another entity even if it holds less than half of the voting rights of that entity.
- 27 A reporting entity with less than half of the voting rights has the power to direct the activities of another entity if:
- (a) the reporting entity has more voting rights than any other party; and
  - (b) the reporting entity's voting rights are sufficient to give the reporting entity the ability to determine the entity's strategic operating and financing policies.
- 28 For example, a reporting entity can have the power to direct the activities of another entity if the reporting entity is the dominant shareholder that holds voting rights and all the other shareholders with voting rights are widely dispersed and are not organised in such a way that they actively co-operate when they exercise their votes so as to have more voting power than the reporting entity.