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| Project | Consolidation |
| | Power to direct the activities of another entity (Part II) |
| Topic | – Options and convertible instruments - |

Introduction

1. Agenda paper 10B discusses a reporting entity's power to direct the activities of another entity in the context of a shareholder without a majority of the voting rights. The objective of this paper is to expand this discussion to situations in which a reporting entity holds options or convertible instruments (hereafter referred to as 'options') that, if exercised or converted, would provide it with voting rights in another entity.
2. This paper:
 - (a) explains the proposed requirements in the ED;
 - (b) summarises respondents' and round table participants' comments;
 - (c) analyses whether an unexercised option could give a reporting entity the current power to direct another entity;
 - (d) discusses in which situations an unexercised option gives its holder power to direct the activities of another entity; and
 - (e) addresses selected drafting issues.

Summary of the requirements in the ED

3. Paragraph B13 of the ED requires a reporting entity to consider whether rights from holding options to obtain voting rights, taken in conjunction with other
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The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

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facts and circumstances, give the reporting entity the power to direct the activities of another entity. The ED provides three examples of the circumstances in which a reporting entity that holds options meets the power element:

- (a) The governing body of another entity determines strategic operating and financing policies in accordance with the wishes of the reporting entity.
- (b) A party with voting rights that is the counterparty to an option agreement acts as an agent for the reporting entity and those voting rights are sufficient to give the reporting entity power.
- (c) The option agreement gives the reporting entity particular rights relating to the strategic operating and financing policies that give the reporting entity power.

Paragraph B13 is reproduced in the Appendix to this paper.

- 4. In addition, paragraphs BC85 and BC86 clarify that:
 - (a) a reporting entity that is required to transfer little, or no, consideration to exercise an option over shares is likely to have control of those shares.
 - (b) if an option to acquire shares in an entity is exercisable at a price that equals the fair value of those shares, the option holder does not obtain a return from those shares until that option is exercised and does therefore not meet the returns element of the control definition.
- 5. Three Board members expressed an alternative view in the ED because they thought that the proposed requirement was inconsistent with the assessment of power of a passive majority shareholder and highlighted that the Board had not resolved whether the principle for consolidation is in fact being in control or having the ability to be in control.

Summary of respondents' comments

6. Most respondents agreed with the principle that options, taken in conjunction with other facts and circumstances, might give a reporting entity the power to direct the activities of another entity. They agreed, therefore, that a conclusion that options always or never give the holder control would be likely to cause inappropriate consolidation in some cases and failure to do so in others.
7. However, many thought that the principle was expressed ambiguously and was open to different interpretations. As a consequence, many respondents agreed with the principle, even though they held different views on whether and how options should be considered in the assessment of power. Some respondents believed that paragraphs BC74 – BC87 of the Basis for Conclusions expressed the principle more clearly and asked the Board to incorporate some of those explanations in the standard.
8. Most respondents disagreed with the application guidance in the ED. Respondents were particularly concerned about the example reproduced in paragraph 3(a) of this paper according to which a reporting entity meets the power element of the control definition if the governing body of another entity determines strategic and operating policies in accordance with the wishes of the reporting entity. Respondents noted that if the reporting entity's interests are broadly aligned with those of the other entity, it would always appear that the entity's governing body determines its strategic and operating policies in accordance with the wishes of the reporting entity, even though it might never have had any influence on the decision making.
9. Many respondents agreed with the proposals that concluded that currently exercisable options would not always give the holder the power to direct the activities of an entity. In contrast, some agreed with the alternative view that currently exercisable options would give the holder power.
10. Most respondents emphasised that the Basis for Conclusions should not contain application guidance and that, if the Board should affirm paragraphs BC85 and BC86, they should be incorporated into the standard. However, respondents had mixed views on that guidance. While some agreed with the observations in

paragraphs BC85 and BC86, others believed that the guidance went beyond the principle as expressed in the standard. For example one respondent stated:

We think the guidance in paragraph BC85 would be more useful were the paragraph expanded to explain that usually having control is more desirable than not having control, so usually an entity would expect to pay something to acquire control. It follows that, if a reporting entity holds some options that, if exercised, would clearly give it the voting rights it would need to control a second entity and those options could be exercised for little or no cost, this is an indicator that it might already have control. We also consider that in determining whether the reporting entity already has control both the power and returns criterion must be present; and

We think paragraph BC86 makes an important unstated assumption, which is that the options represent the only link between the two entities. If that is indeed the case, it follows that one needs to consider the return the reporting entity receives on the options to establish whether the return criterion is met. However, if there are other links, what matters is the reporting entity's overall relationship with the second entity (taking the unexercised/unconverted options/convertibles into account).

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11. Respondents asked the Board for further clarifications on the drafting of the application guidance. Some of those issues are briefly discussed in paragraph 38 of this paper.
12. In light of the many concerns about the application guidance for options and convertible instruments, some respondents suggested that the Board should only state the principle that it intends to apply to options, but should not provide further application guidance,
13. We have structured our analysis of options into the following questions:
 - (a) Can an unexercised option give a reporting entity the power to direct the activities of another entity?
 - (b) If so, in which situations would that option give the holder that power?

Can an unexercised option give a reporting entity the power to direct the activities of another entity?

14. Many respondents noted that the ED was not clear about when a reporting entity should consider its power from options or convertible instruments **in**

conjunction with other facts and circumstances. Respondents interpreted the principle in different ways:

- (a) **Future power:** Some respondents argued that an unexercised option, by itself, never gives the holder the current power to direct the activities of another entity. They view an option as giving the holder the contractual right to obtain voting power in the future. It does not give the holder power today. However, when considered together with other contractual arrangements (eg voting rights, loan agreements, agreements with shareholders), the option holder could have the current power to direct the activities of the entity.
- (b) **Rights:** Other respondents thought that an unexercised option could, but would not always, give the holder the current ability to direct the activities of another entity. In their view, an option holder's current power arises from the contractual rights within the option—the right to obtain voting rights and, in turn, to direct the activities of the entity. If the option holder has the current ability to exercise the option, the option holder has the current ability to direct the activities of the entity. Some with this view agree with the alternative view in the ED that the holder of currently exercisable options always has the current ability to direct the activities of the entity. Others with this view argue that other factors should be considered to determine whether the option is, in fact, currently exercisable. Judgement is required to assess whether there are any barriers to exercise.
- (c) **Threat:** Other respondents also thought that an unexercised option could, but would not always, give the holder the current ability to direct the activities of another entity, but for different reasons. In their view, an option holder has the current ability to direct the activities of the entity when the threat of exercising the option is such that the governing body of the entity would take decisions according to the wishes of the option holder (reflecting the proposals in paragraph B13(a) of the ED). Assessing whether the option is a threat requires

judgement, including an assessment of the terms of the option agreement.

15. Participants at the round tables had mixed views on options. Most did not think that a currently exercisable option always gave the holder power. They believed that, when assessing power, judgement was required to determine the influence of the option. Some held the ‘future power’ view and believed that an option, in and of itself, does not give the holder power.
16. We think that an option can, but won’t always, give the holder the current ability to direct the activities of another entity—ie we do not support the ‘future power’ view. We acknowledge that a reporting entity that holds voting rights or has other contractual arrangements with an entity, as well as options, is more likely to meet the power element of the control definition. However, holding voting rights or having other contractual arrangements with an entity should not be a mandatory requirement for the reporting entity to have power.
17. Paragraphs 5-11 of Agenda Paper 10B set out the characteristics of power. Three of those characteristics are:
 - (a) Power must be current—the mechanism that enables the reporting entity to direct the activities of another entity must be in place today.
 - (b) Power precludes others from controlling the entity. Put another way, a reporting entity must have the current ability to enforce its will and others are unable to prevent it from doing so on the basis of the current facts and circumstances. Accordingly, a reporting entity has the current ability to direct the activities of the entity.
 - (c) Power need not be exercised.
18. If the power element of the control definition was characterised as requiring either the legal right to direct the activities or active direction of the activities, we would agree that the holder of unexercised options would never meet the power element in the absence of other contractual arrangements. However, this is not the case. Consequently, we do not think that the ‘future power’ model is a consistent application of the characteristics of power in the ED.

19. The next section of the paper explores the ‘threat’ view and the ‘rights’ view in more detail.

In which situations does an unexercised option give the holder the power to direct the activities of another entity?

The ‘rights’ view

The alternative view in the ED: Currently exercisable options always give the holder power

20. The alternative view in the ED regarding options states that the holder of a currently exercisable option over a sufficient number of voting rights meets the power element of the control definition. That option holder is, in effect, in the same position as a passive dominant or majority shareholder. This is because the option holder has the current right to ‘step in’, exercise the option and subsequently exercise its voting power at any time to enforce its will. Therefore, they would conclude that the holder of a currently exercisable option always meets the power element because it always has the *ability* to exercise power and enforce its will, irrespective of whether it actually does. However, those supporting the alternative view would agree with the conclusion in paragraph BC86 that a fair value option would fail to meet the returns requirement of the control definition and should not result in consolidation.
21. Supporters of this view argue that the option must be currently exercisable. They think that an option holder only has the current ability to exercise power if the contractual right within the option agreement is exercisable today. If an option is exercisable only in the future, they cannot see how the option holder could have the current ability to enforce its will. If the governing body decides to ignore the wishes of the option holder, that option holder has no means of enforcing its will today. They believe that being currently exercisable is necessary to ensure consistency with the characteristics of power and how they are applied to a passive majority shareholder, a dominant shareholder (discussed in Agenda Paper 10B) and, indeed, a principal in an agency relationship. In each of those situations, the reporting entity with power has the current ability to

act if and when it needs to because of contractual rights that it holds, in a similar way to the holder of currently exercisable options.

Other factors are relevant, in addition to being currently exercisable

22. Others agree to a large extent with the alternative view in the ED, and in particular, that the option must be currently exercisable for the reasons set out in paragraph 21. They would not, however, conclude that being currently exercisable means that the holder always has the current ability to enforce its will and thereby direct the activities of an entity. There may be practical or economic barriers that prevent the option holder from being able to exercise its options and, thus, enforce its will. For example, the holder of options that are deeply out-of-the-money is unlikely to be able to exercise its options from an economic perspective. An option holder that lacks the financial ability to exercise an option is prevented from exercising from a practical perspective because of difficulty in obtaining credit.
23. Therefore supporters of this view would require the holder of currently exercisable options to apply judgement when assessing whether the options are currently exercisable from an economic and practical perspective—paragraphs 31-36 of this paper discusses the relevant factors to consider in more detail. If there are barriers that, in effect, prevent the holder from exercising the options, the option holder would not meet the power element of the control definition.
24. Supporters of this view believe that the view consistently applies the characteristics of power. A majority shareholder is able to control an entity even though it can take time to organise a meeting and exercise its voting rights. In a similar manner, it can take time for a principal to ‘kick out’ an agent. An option holder also has steps to take to exercise its rights. In each case, the question is whether those steps prevent the reporting entity from having the current ability to direct the activities of another entity.

The ‘threat’ view

25. Some interpret the proposals in the ED (paragraph B13(a) reproduced in the appendix to this paper) to say that current power comes from the ‘threat’ within

the option when the threat of exercising the option is such that the governing body of the entity would take decisions according to the wishes of the option holder. Judgement would be required to assess whether the terms of the option are such that the potential exercise of the option is a sufficient threat to assume that the option holder could force the governing body to act according to its wishes. Paragraphs 31-36 of this paper discuss the relevant factors to consider in more detail.

Must the options be currently exercisable?

26. The proposals in the ED did not require the option to be currently exercisable when assessing whether an option holder has the power to direct the activities of an entity. The proposals implied that being currently exercisable is an important factor to consider when assessing power—ie the closer an option is to being exercisable, the more of a threat it poses. Paragraph BC87 of the ED noted that ‘the holder of options that are exercisable today is more likely to have control than the holder of options that are not exercisable until some point in the future’. However, the Board did not think that it was a necessary condition. An option that is not exercisable today, but could be exercised in the near future, could pose the same threat as a currently exercisable option and, thus, ensure that the option holders wishes are met.
27. Some who support the ‘threat’ view, however, would argue that the option could only ever be a sufficient threat to ensure that the option holder can enforce its will if the option is currently exercisable. This is because the holder of options that are not currently exercisable cannot, by law, enforce its will—ie the governing body could choose to ignore the wishes of the option holder and, today, that option holder would not be able to act to enforce those wishes.
28. Those who do not think that the option must be currently exercisable would argue that restricting power to exclude the consideration of options that are not currently exercisable draws the wrong line. For example, suppose that a currently exercisable option that is deeply in-the-money and requires little consideration to exercise gives the holder the current ability to enforce its will. Those supporters would argue that it is artificial to conclude that a similar option

that is exercisable in, say, two months time would pose any less of a threat. They would conclude that such an option would also give its holder the current ability to enforce its will and, thus, to direct the activities of an entity.

Staff recommendation

29. The staff are divided in their views. Some staff support the ‘threat’ view—they think that current power comes from the threat within the option being such that the activities of an entity are directed according to the wishes of the option holder (paragraph 25 of this paper). Other staff support the ‘rights’ view—they think that current power comes from having the right to exercise the option today. Those staff who support the ‘rights’ view do not, however, think that a currently exercisable option always gives the holder power but that other factors should also be considered to assess whether there are any barriers to exercise (paragraphs 22-24 of this paper).
30. One staff member that supports the ‘threat’ view believes that an option does not have to be currently exercisable for the reasons given in paragraph 28. In contrast, the majority of the staff believe that an option should be currently exercisable.

Factors other than being currently exercisable that are relevant when assessing whether an option holder meets the power element of the control definition

31. Although the staff have different views on whether power comes from the ‘threat’ or the ‘right’ within the option agreement and on whether options are required to be currently exercisable, all staff members agree on the other factors that are relevant when assessing whether an option holder meets the power element of the control definition. Those factors include the terms of the option agreement that demonstrate whether the exercise of the option is capable of generating positive returns for the option holder. If the option is capable of generating positive returns for the holder, it is likely that there are little or no barriers to exercise (supporting the ‘rights’ view set out in paragraph 22-24 of this paper) or that the option poses a threat such that the option holder can

enforce its will (supporting the ‘threat’ view set out in paragraphs 25-27 of this paper).

32. We were informed at the round tables that it is usually clear when an option is written with the intention of giving the holder control—the pricing and terms of the option agreement will reflect the likelihood that it will be exercised (in that situation, the option is likely to be capable of generating position returns). In contrast, an option that is written with the intention of never being exercised or for protective purposes will be priced to reflect those factors.
33. We consider that the exercise of options is generally capable of generating positive returns when an option is in-the-money. However, this factor is neither necessary nor individually determinative. For example, a reporting entity might exercise an option that is out-of-the money to realise synergies or other returns that are not embodied in the option. On the other hand, a reporting entity might, for example, lack the financial ability to exercise an option that is in-the-money. We believe that the application guidance should explain those concepts.
34. Paragraphs BC85 and BC86 provide further guidance when assessing whether an option holder has power:
 - (a) a reporting entity that is required to transfer little, or no, consideration to exercise an option over shares is likely to have control of those shares.
 - (b) if an option to acquire shares in an entity is exercisable at a price that equals the fair value of those shares, the option holder does not obtain a return from those shares until that option is exercised and does therefore not meet the returns element of the control definition.
35. Some staff believe that paragraphs BC85 and BC86 provide helpful illustrations of the assessment of options and convertible instruments in particular situations. Therefore, those staff would incorporate those paragraphs in the application guidance of the final standard. However, they would amend the wording in paragraph BC86 to clarify that the exercise price of an option would not need to be at fair value, but would need to equal the returns that the reporting entity

would receive from the exercise. This would include any indirect returns from the exercise, such as synergies.

36. Other staff are concerned that the illustrations in paragraphs BC85 and BC86 might distract from the assessment of all facts and circumstances, while providing little additional guidance. In particular, they believe that the broad definition of returns in the ED would make it impracticable to assess whether the exercise price of an option equals the returns that the reporting entity would receive from its exercise.

Currently exercisable

37. Should the Board support the ‘threat’ view without requiring an option to be currently exercisable, we recommend adding application guidance that explains that the closer an option is to being exercisable, the more likely it is that the holder can enforce its will and thus would have power to direct the activities of an entity.

Questions for the Board

1. Do Board members support (a) the ‘threat’ view (ie the view expressed in paragraph 25 of this paper) or (b) the ‘rights’ view (ie the view expressed in paragraphs 20-24 of this paper)?
2. If Board members support the ‘threat’ view, must the options be currently exercisable?
3. If Board members support the ‘rights’ view:
 - (i) does a currently exercisable option always gives the holder the power to direct the activities of an entity (ie the view expressed in paragraphs 20-21 of this paper), or
 - (ii) should other factors be considered to assess whether there are any barriers to exercise (ie the view expressed in paragraphs 22-24 of this paper)?
4. Do Board members believe that paragraphs BC85 and BC86 of the ED should be incorporated into the application guidance? Are the Board members aware of additional indicators that should be included in the application guidance, other than those discussed in paragraphs 31-37 of this paper?

Drafting issues

38. Respondents had the following additional questions on the wording in the ED:

- (a) Should the application guidance apply to options and convertible instruments only or apply to all instruments that were included in the definition of potential voting rights in IAS 27?

When drafting the ED we did not intend to amend the scope of instruments to be included in the assessment of power. We believe that the application guidance should, in addition to options and convertible instruments, apply to all instruments that have the potential, if exercised or converted, to give the reporting entity voting rights or reduce another party's voting rights in another entity. Thus, the application guidance should apply to all potential voting rights.

- (b) Does the application guidance require that a reporting entity actually direct the activities of the other entity or is it sufficient if it has the ability to do so?

Paragraph 8 of the ED states that a reporting entity need not have exercised its power to direct the activities of an entity to control that entity. We believe that to be consistent with this principle, a reporting entity meets the power element when it has the ability to direct the activities of another entity because of options. The actual exercise of that power is not necessary.

Some respondents argued that, because of the difficulties in assessing power from options, the Board should make an exception from that principle and require the actual exercise of power in the case of options and convertible instruments. Although we understand those concerns, we do not recommend that the Board make an exception from the principle in paragraph 8 of the ED because it would create an inconsistency within the standard. We refer to our discussion in paragraphs 47 of agenda paper 10B.

39. We intend to clarify these issues when drafting the final standard.

Appendix – Extracts from the ED

Options and convertible instruments

B13 When assessing control, a reporting entity considers whether its power from holding options or convertible instruments to obtain voting rights, taken in conjunction with other relevant facts and circumstances, gives it the power to direct the activities of another entity. A reporting entity that holds options or convertible instruments has power to direct the activities of another entity if (a), (b) or (c) applies:

- (a) the governing body of that entity determines strategic operating and financing policies in accordance with the wishes of the reporting entity. This might be the case if, for example, the reporting entity holds voting rights together with options or convertible instruments to obtain voting rights that, if exercised or converted, would give the reporting entity voting rights sufficient to determine the entity's strategic operating and financing policies.
- (b) any party with voting rights that is the counterparty to an option agreement acts as an agent for the reporting entity and those voting rights are sufficient to give the reporting entity the ability to determine the entity's strategic operating and financing policies.
- (c) the option or conversion agreement gives the reporting entity particular rights relating to the strategic operating and financing policies that enable the reporting entity to have the power to direct the activities of the entity.