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Project	<b>Consolidation</b>
Topic	<b>Control through voting rights</b>

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## Introduction

1. Paragraph 4 of ED 10 *Consolidated Financial Statements* (ED 10) defines control as the power to direct the activities of another entity to generate returns for the reporting entity. At its October 2009 meeting, the IASB decided tentatively that power has the following characteristics; power:
  - (a) refers to a reporting entity's current ability to enforce its will in directing the activities of an entity that significantly affect the returns
  - (b) need not have been exercised
  - (c) need not be absolute
  - (d) is assessed on the basis of current facts and circumstances.
2. The IASB agreed that it would revisit those characteristics when discussing control with less than half of the voting rights of an entity.
3. FASB Statement No. 167, *Amendments to Interpretation No. 46(R)*, defines control for variable interest entities as:

A reporting entity with a variable interest or interests that provide the reporting entity with a controlling financial interest in a variable interest entity will have both of the following characteristics:

- a. The power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance

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This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

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 FASB or the IASB.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

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- b. The obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity.
- 4. The purpose of this paper is to discuss how the power element of those definitions of control would be applied when assessing control of an entity that is controlled through voting rights. The question addressed in this paper is **when are a reporting entity’s voting rights *sufficient* to give it the power to direct the activities of an entity (ie sufficient to give it the ability to direct the activities of an entity that significantly affect the returns (or, in the words of Statement No.167, to direct the activities that most significantly impact the entity’s economic performance))?**<sup>1</sup> Please note that this paper discusses control in relation to entities controlled through voting or similar rights. However, the staff request that the boards consider the analysis and recommendations within this paper together with those in agenda papers 3B, 3C and 3D that also discuss the application of the control model.
- 5. For simplicity, this paper assumes that the strategic operating and financing decisions about the activities of the entity are made by a simple majority vote, or a majority of the members of the governing body are appointed by a simple majority vote. Throughout the paper, when we refer to the appointment of the board or governing body, it is assumed that that board or governing body makes the strategic operating and financing decisions about the activities of the entity.

**The current requirements of IAS 27 and ARB 51, as amended**

- 6. IAS 27 *Consolidated and Separate Financial Statements* provides the following guidance regarding the assessment of control of an entity that is controlled by voting rights:

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<sup>1</sup> Throughout this paper, we use the phrase ‘the activities of an entity that significantly affect the returns’. That phrase is also used to convey the wording of the power element of the control definition in Statement No.167 ‘the activities of an entity that most significantly impact the entity’s economic performance’.

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- 13 Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity when there is:
- (a) power over more than half of the voting rights by virtue of an agreement with other investors;
  - (b) power to govern the financial and operating policies of the entity under a statute or an agreement;
  - (c) power to appoint or remove the majority of the members of the board of directors or an equivalent governing body and control of the entity is by that board or body; or
  - (d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.
7. We understand that, in practice, the guidance in paragraph 13 of IAS 27 is often applied to conclude that a reporting entity that owns less than half of the voting rights of an entity does not control that entity in the absence of formal arrangements that would give it the majority of the voting rights.
8. Accounting Research Bulletin 51, *Consolidated Financial Statements*, as amended by FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*, provides the following guidance:

The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one entity, directly or indirectly, of more than 50 fifty percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. However, there are exceptions to this general rule. A majority-owned entity shall not be consolidated if control does not rest with the majority owner (as, for instance, if the entity is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the entity).

All majority-owned subsidiaries—that is, all entities in which a parent has a controlling financial interest through direct or indirect ownership of a majority voting interest—shall be consolidated.

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9. Historically, according to US GAAP, a reporting entity has usually consolidated a voting interest entity when it holds the majority of another entity's voting or similar rights. In other words, US GAAP currently does not employ a control model for voting interest entities that would conclude that a reporting entity controls another entity in situations in which the reporting entity holds less than half of another entity's voting or similar rights, regardless of what power those rights give the reporting entity.<sup>2</sup>

**The proposals in ED10 and the exposure draft published by the FASB in 1999<sup>3</sup>**

10. The proposals included in ED10 and those included in the exposure draft published by the FASB in 1999 are similar regarding entities controlled by voting rights (paragraph 13 of this paper summarises the proposals included in the 1999 FASB ED relating to entities controlling by voting rights).
11. Paragraphs 27 and 28 of ED10 proposed the following to address situations in which a reporting entity holds less than half of the voting rights of an entity (and does not have rights from other contractual arrangements):
  - 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 which a way

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<sup>2</sup> ASC Topic 810-10-15-8 provides that the usual condition for a controlling financial interest is ownership of a majority voting interest and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of over 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. However, the power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

<sup>3</sup> The FASB published two exposure drafts addressing consolidation in the 1990s—one in 1995 and the second in 1999. We have included some background in this paper regarding the proposals in the second exposure draft. The proposals in both exposure drafts were not issued as final standards.

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that they actively co-operate when they exercise their votes so as to have more voting power than the reporting entity.<sup>4</sup>

12. Many respondents asked for additional clarity about how to apply those requirements, and questioned what size of shareholding might be sufficient to conclude that that shareholder meets the power element of the control definition. Most believed that the proposals would be difficult to apply. Some suggested that a minority shareholder could never control another entity without other contractual rights. Others suggested that evidence of control should be required to conclude that a minority shareholder controlled another entity.
13. The FASB issued an Exposure Draft in February 1999, *Consolidated Financial Statements: Purpose and Policy* (the 1999 ED). In the absence of evidence that demonstrates otherwise, the 1999 ED included (among others) a rebuttable presumption of control when a reporting entity has a large minority voting interest in the election of an entity's governing body and no other party or organised group of parties has a significant voting interest. The guidance within the 1999 ED was never issued in a final standard. The primary reason given for not issuing a final standard was the significant concerns presented by constituents regarding the operability of the control model, including what level of rights and economics must be held by an individual reporting entity to conclude that the reporting entity, indeed, held a controlling financial interest. The 1999 ED also focused on special purpose entities for which guidance was finalised in Interpretation 46(R) *Consolidation of Variable Interest Entities* in 2003 and amended in June 2009 through Statement No.167.
14. The FASB Board issued the following press release in January of 2001:

The Financial Accounting Standards Board's (FASB's) Consolidation Policy project has been focused on developing new standards that would determine which affiliates would be included in consolidated financial statements. The FASB had previously planned to issue both a final statement and an exposure draft on different aspects of this project in the second quarter of 2001.

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<sup>4</sup> The term 'widely dispersed' is used in ED10 and in this paper to refer to situations in which the other shareholdings are held by numerous unrelated parties.

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After careful consideration by all FASB Board members, the FASB has determined that, at this time, there is not sufficient Board member support to proceed with either a final statement on consolidation policy, or an exposure draft on entities with specific limits on their powers (SPEs). However, the Board continues to believe that improved guidance in the area of consolidation policy is desirable and has asked the FASB staff to reassess the approach for providing that guidance.

Several FASB Board members are concerned about the appropriateness of determining that non-shared decision-making ability can exist based on the anticipated non-action by other holders of voting rights. They also are concerned about whether the proposed treatment of convertible and option instruments that give the ability to obtain voting rights is effective as well as the operability of certain other provisions. However, the Board believes its effort to deal with consolidation policy issues should continue. Those efforts should include the need to develop effective guidance for SPEs, to deal with situations where control exists but is not apparent based on the form of the arrangement and to provide guidance on partnership and other non-corporate structures. It also believes that the work to define "control" has been useful and that this effort should continue.

15. Since publishing the 1999 ED, the FASB has concentrated its efforts on dealing with the consolidation of structures referred to in the above press release as SPEs.

### Staff views

16. This section of the paper includes the staff views regarding holding:
  - (a) more than half of the voting rights in an entity (paragraphs 17 and 18);
  - (b) less than half of the voting rights together with rights in other contractual arrangements (paragraphs 19 and 20); and
  - (c) less than half of the voting rights in an entity without rights in other contractual arrangements (paragraphs 22-57).

### *Holding more than half of the voting rights in an entity*

17. In the absence of other arrangements, a reporting entity that holds more than half of the voting rights in an entity has the power to direct the activities of that

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entity. This is because the right to cast a majority of the votes at shareholder meetings is sufficient to give that reporting entity the ability to direct the activities of the entity that significantly affect the returns (ie to make substantive decisions about the activities that matter).

18. Holding more than half of the voting rights in an entity provides evidence of a reporting entity's ability to direct the activities of an entity. Additional evidence of that ability is not required. The reporting entity has the contractual right to cast a majority of the votes at shareholder meetings. It is therefore evident that the reporting entity has the ability to enforce its will in directing the activities that matter, irrespective of whether it exercises its voting power.

***Holding less than half of the voting rights in an entity together with rights in other contractual arrangements***

19. A reporting entity with less than half of the voting rights in an entity can have the power to direct the activities of that entity. The reporting entity can have that power by different means:
  - (a) An agreement between a reporting entity that owns less than half of another entity's voting rights and other vote holders can give the reporting entity the contractual right to exercise a majority of the voting rights. For example, a shareholders agreement that states that Shareholder A, which owns 45% of Entity B, has the right to appoint a majority of the members of the governing body of Entity B.
  - (b) Similarly, other forms of contractual arrangement can give the reporting entity the ability to direct the activities of another entity that matter when combined with voting rights. Therefore, a party that holds less than half of the voting rights in an entity might have the ability to direct the activities that matter if it also holds, for example, rights within contractual arrangements relating to the significant activities of the entity (eg a cornerstone holding of voting rights might prevent other vote holders from changing the contractual arrangements the reporting entity uses to direct the activities of another entity).

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20. In the situations described above in paragraph 19, the reporting entity has the *legal or contractual ability* to direct the activities of an entity that matter. As such, and similar to a reporting entity that holds more than half of the voting rights in an entity, it is evident that the reporting entity meets the power element of the control definition, irrespective of whether it has exercised its rights. No additional evidence of power is required.
21. When a reporting entity holds less than half of the voting rights in an entity and there are no other contractual arrangements that provide it with the ability to direct the activities of another entity, **when and what evidence is needed to conclude that the reporting entity's voting rights are sufficient to give it the ability to direct the activities of an entity that significantly affect the returns?**

***Holding less than half of the voting rights in an entity without rights in other contractual arrangements***

22. When a reporting entity holds less than half of the voting rights in an entity (and without holding rights within other contractual arrangements), that entity does not have the legal or contractual right to enforce its will. This is because the other vote holders could collectively outvote the reporting entity if they chose to do so.
23. Respondents to ED10 had mixed views on whether a reporting entity could ever control another entity without the legal or contractual right to direct the activities.

***'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 contractual rights***

24. Some respondents to ED10 and some staff support a 'contractual rights' view. They would argue that a reporting entity with less than half of the voting rights of an entity (and without other contractual rights) cannot control that entity. This is because the reporting entity contractually does not have the right to participate in the operating and financing activities of the other entity. The 'contractual rights' view sees the position of the other shareholders as similar to



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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 could vote against those actions and prevent the reporting entity from directing the activities of the other entity.

25. Staff supporting this view emphasise that it does not matter whether the other shareholdings are widely dispersed because those shareholders 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 votes of those shareholders would be sufficient to block the actions of the reporting entity.
26. Therefore, staff supporting the ‘contractual rights’ view would clarify that a reporting entity without a majority of the voting rights cannot direct the activities of another entity unless other contractual arrangements are in place that give it the ability to do so. Therefore, those staff recommend that the final standard state that a reporting entity has the ability to direct the activities of an entity that significantly affect the returns only when it has the legal or contractual ability to direct those activities.
27. Proponents and staff supporting this view believe that this clarification would not significantly change the intended scope of entities to be consolidated when compared to ED10. 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.
28. These staff note that most of the investors that the staff held conversations with believe that a reporting entity should consolidate another entity only when it has the contractual right to direct the activities (refer to paragraphs 32-35 of this paper for further information). The staff supporting this view also note that this view is somewhat consistent with current US GAAP consolidation guidance in that control and consolidation is based on an entity’s contractual ability to direct the strategic and operating decisions of an entity along with being exposed in

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some manner to the variability associated with the economic performance of that entity.

29. The staff supporting this view also believe that potentially relying on historical voting patterns and the ability of a reporting entity to appoint the governing body due to the inactivity of other shareholders is not a sound basis for determining control. Because the governing body has a fiduciary duty to act in the best interest of all of its shareholders and, in the absence of contractual rights giving a party the right to direct the activities or a majority shareholder, it is not practicable to conclude that the reporting entity “controls” the other entity.
30. Staff supporting this view believe that a factor to be considered in the ‘dominant shareholder’ view (set out in paragraphs 36-57 of this paper) is the possibility that the dominant shareholder may remove the majority of the governing body at the next election (for example, annual appointment). Although this may not be the primary basis for the ‘dominant shareholder’ view, the staff supporting the ‘contractual rights’ view believe that the possibility of removal may be based on the “threat” that if the governing body does not perform as the dominant shareholder desires, the dominant shareholder may have the ability to remove the governing body. Staff supporting the ‘contractual rights’ view believe that consolidation based in part on the “threat” of removal of the governing body is not indisputable evidence that the dominant shareholder controls another entity for an entire operating cycle.
31. The staff supporting this view also believe that the operational challenges and potential for inconsistent application of a ‘dominant shareholder’ approach could inevitably result in inconsistent consolidation results among preparers.

Views expressed by investors regarding control through voting rights

32. In December 2009, the staff had conversations with several US investors, and user groups outside the US, to ascertain when consolidation would be appropriate and useful in their analysis of a reporting entity’s financial condition. All of these investors supported consolidation when a reporting entity held the majority of another entity’s voting rights. However, the majority of the investors did not support consolidation in situations in which an entity

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held less than half of another entity's voting rights and did not have the contractual right to direct the strategic and operating decisions of another entity. In other words, those investors were interested in consolidation only when a reporting entity was contractually "running the show." Many of these investors did not support consolidation in situations in which a "dominant minority shareholder" historically appointed the governing body of another entity through the inactivity of other shareholders.

33. Investors were concerned that, without the contractual ability to direct the activities of another entity, basing consolidation on the inactivity of other shareholders would result in too many entities being consolidated. They further expressed concern that there would be the potential for frequent changes in consolidation/deconsolidation conclusions (and potential gains being recognised on deconsolidation) that may result in inconsistent application and financial statements that were misleading.
34. Other investors thought that there were situations in which a minority shareholder should consolidate another entity regardless of whether the minority shareholder has the contractual right to direct. In particular, these investors cited situations in which a minority shareholder was actively involved in the operations of the entity (either directly or by appointing a majority of the board) or when the activities of an entity were economically dependent on the activities of a dominant minority shareholder.
35. Investors believe that additional relevant information (key financial data) should be required in the notes to a reporting entity's financial statements for all entities in which the reporting entity has a significant shareholding and/or is actively involved in the operations of the entity, regardless of whether the entity is consolidated. However the majority of the US investors consulted would prefer disclosures in the notes rather than consolidation when a reporting entity holds less than half of the shares in an entity and does not have the contractual right to direct the activities of the entity.

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***'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 contractual rights***

36. Some respondents to ED10 and some staff agree with a 'dominant shareholder' view in which a reporting entity can have the ability to direct the activities of another entity even though it holds neither the majority of the voting rights in that entity nor other rights in other contractual arrangements (the view proposed in ED10 and in the FASB 1999 ED).
37. This is because the members of the governing body of an entity (particularly listed entities) are often appointed by a majority of votes cast at a shareholders meeting (and ordinary resolutions can be passed by a majority of votes cast at a shareholders meeting). Therefore, those staff believe that a reporting entity holding a significant minority interest can have the ability to direct the activities that matter, particularly when the other shareholders have not organised themselves to give them collective control. The difficulty is to determine when the reporting entity's voting rights are such that they give the reporting entity that ability to direct the activities of the other entity.
38. Many respondents argued that the proposed guidance in ED10 (set out in paragraph 11 of this paper) would be difficult to apply because they thought that:
- (a) ED10 may require a reporting entity to consolidate another entity simply 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 (eg 5% or 10%). Respondents believed that, in those circumstances, the reporting entity is 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 (eg 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.

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- (b) ED10 may force 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) ED10 may 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.
39. In July 2009, to address the application issues raised, the IASB staff recommended that the final standard should include some guidance to assist in determining whether a minority shareholding is sufficient to give the reporting entity the ability to direct the activities that matter, as follows:
- (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.<sup>5</sup>

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<sup>5</sup> Agenda paper 10B, July 2009.

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40. At the July meeting, all IASB members agreed that a reporting entity can meet the power element of the control definition with less than half of the voting rights in an entity. However the IASB members were divided in their views on how to address this in the final consolidation standard.
41. One way to proceed would be to add some guidance to help assess when a reporting entity that holds less than half of the voting rights of an entity has the ability to direct the activities. Factors to consider in making that assessment include:
- (a) the size of the reporting entity's holding of voting rights relative to the size and dispersion of holdings of the other shareholders (incorporating the guidance proposed at the July meeting, reproduced in paragraph 39 of this paper).
  - (b) whether the other shareholders or a group of the other shareholders are organised to vote together.
  - (c) the nature of the other shareholders (ie institutional investors tend to hold more significant shareholdings and be more active than retail investors).
  - (d) the number of shareholders attending previous shareholders meeting (this does not necessarily indicate whether a reporting entity has current power but, assuming that the shareholder base has not changed significantly, it is an indicator of whether the reporting entity could be expected to be able to direct the activities).
42. Although the staff think that adding the factors listed in paragraph 41 would help when assessing control, the staff acknowledge that it remains very difficult to assess when a minority shareholding is sufficient to give the holder the ability to direct the activities that matter. The real concern is being confident that a reporting entity with less than half of the voting rights really has power and providing guidance on how to make that judgement.
43. Therefore, the staff supporting the 'dominant shareholder' view would suggest that, when a reporting entity holds less than half of the voting rights in an entity (without other contractual rights), one way to be confident that a reporting entity has the ability to direct the activities of the entity is when there is *evidence* of

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that ability (ie when the reporting entity has taken actions that provide evidence that it, in effect, has the ability to direct the activities). Therefore, those staff recommend that evidence of a reporting entity's ability to direct the activities of an entity should be required when the reporting entity holds less than half of the voting rights in an entity (without other contractual rights).

44. Appointing the majority of the members of the governing body would typically provide *evidence* of the ability to direct the activities that significantly affect the returns.<sup>6</sup>
45. A reporting entity would also consider the following indicators of the ability to direct the activities that matter. These indicators (either individually or collectively) could provide another form of evidence:
  - (a) The reporting entity can dominate the process of appointing the governing body. Examples of indicators are:
    - (i) dominating the nominations process of electing members of the entity's governing body or obtaining proxies from other holders of voting interests; and
    - (ii) appointing members to fill vacancies on the entity's governing body until the next election.
  - (b) The reporting entity shares resources or non-financial assets with the entity. For example, the entity and the reporting entity might have the same members of their governing bodies, or share key management personnel or other staff.
  - (c) The majority of the entity's key management personnel are current or previous employees of the reporting entity, which also holds the largest number of voting rights or has the largest investment in the entity.
  - (d) The reporting entity has the ability to direct the entity to enter into, or veto any changes to, significant transactions that benefit the reporting entity.

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<sup>6</sup> The reporting entity need not have appointed those members at the most recent meeting if a majority of the members were appointed by the reporting entity at a previous meeting, and those members continue to hold seats on the governing body.

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- (e) The reporting entity has access to the residual assets of an entity, such as:
  - (i) by dissolving the entity and redirecting the use of its assets, or
  - (ii) having access, under a statute or an agreement, to the entity's resources.<sup>7</sup>

*Implications of the staff recommendation to require evidence of power when a reporting entity holds less than half of the voting rights in an entity (without other contractual rights)*

46. Both of the staff views create a distinction between a majority and less than a majority of the voting rights. They, therefore, treat a 51% holding of voting rights different from a 49% holding of voting rights as follows:
- (a) If a reporting entity holds 51% of the voting rights in an entity, it has the ability to enforce its will in directing the activities that matter (in the absence of other factors). The 51% holding provides irrefutable evidence of the ability to direct the activities of an entity. Additional evidence of this ability is not required.
  - (b) If a reporting entity holds 49% of the voting rights in an entity, it meets the power element of the control definition if it has the ability to direct the activities that matter.
    - (i) However, such a reporting entity would be considered to meet that definition only if it has the *contractual ability* to direct the activities of the entity, according to the 'contractual rights' view.
    - (ii) According to the 'dominant shareholder' view, the 49% holding alone would be sufficient to meet the definition only if there is evidence of the ability to direct the activities.
47. Some may disagree with that distinction and question why a line is drawn at 50%. It could be argued that a reporting entity with 49% of the voting rights of

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<sup>7</sup> The indicators in paragraph 45(a)-(e) are mainly those that were included as indicators of power in paragraph B9 of ED10.



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the entity has virtually the same power as a majority shareholder would have, particularly when the other shareholdings are widely dispersed.

48. It may be true that, in particular situations, holding 49% of the voting rights of an entity may give a reporting entity close to the same power as it would have if it held 51% of the voting rights. However, the reporting entity with 49% of the voting rights, in the absence of other arrangements, would not have the legal right to direct the activities of another entity. With 51% of the voting rights, this paper assumes that a reporting entity has the legal right to enforce its will in directing the activities that matter. This is the case in most jurisdictions where 51% of the voting rights in an entity generally gives the holder the right to appoint the majority of the members of the governing body and often pass ordinary resolutions relating to the activities of the entity (in the absence of other contractual arrangements). Such a reporting entity would therefore have the ability to direct the activities that matter in all scenarios (within the boundaries of protective rights). As such, the 51% holding provides evidence of the ability to direct the activities; additional evidence is not required.
49. In contrast, with 49% of the voting rights (and without other contractual rights), a reporting entity does not have the legal right to enforce its will in directing the activities that matter. To enforce its will, it relies either on other shareholders voting in the same way as it does, or on other shareholders not voting at shareholders meetings and exercising their rights. Therefore, we think that a reporting entity with 49% of the voting rights of an entity is in a different position from a reporting entity with 51% of the voting rights. When a reporting entity holds less than half of the voting rights, it is very difficult to determine whether that reporting entity has the ability to direct the activities that matter without further evidence. The lower the percentage of voting rights that a reporting entity holds, the harder it is to make the determination. Therefore staff supporting the 'dominant shareholder' view are recommending that additional evidence of that ability is required.
50. It is important to note that, when a reporting entity with less than half of the voting rights in another entity wishes to control that other entity, the reporting entity will often ensure that it has the contractual ability to direct the activities.

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It would do this by having other rights in contractual arrangements that relate to the activities of the entity, rather than leaving control to chance and relying on other shareholders not attending the shareholders meetings or other shareholders voting as the reporting entity would wish them to. This is particularly the case for private entities for which there is more likely to be a shareholders agreement. In these scenarios, those other arrangements plus the holding of voting rights would provide evidence of the ability to direct the activities without the need for any additional evidence. Therefore, while the issues being discussed in this paper are complicated, we would expect them to arise in a limited number of cases.

51. In addition, the staff supporting the ‘dominant shareholder’ view would assume that if a reporting entity with a large minority shareholding wished to control an entity, it would exercise its voting rights. In that situation, if the reporting entity has the ability to enforce its will, there would be evidence of that ability in that the reporting entity would have been able to appoint the majority of the members of the governing body or pass other resolutions relating to the activities of the entity.
52. Staff supporting the ‘dominant shareholder’ view also acknowledge that their recommendation may result in a delay in consolidation for a limited period when a reporting entity holds less than half of the voting rights in an entity. This may occur if, for example, a reporting entity acquires a large minority shareholding and there is a delay between the acquisition date and the reporting entity exerting its influence (by either nominating/appointing the board or otherwise taking actions that provide evidence of the ability to direct the activities). However these staff believe that any such delay would not be for a significant period. The ‘dominant shareholder’ recommendation to require evidence of the ability to direct the activities is a trade-off that the staff supporting the view believe would improve financial reporting and, yet, would also be operational—the holder of a large minority shareholding (without other contractual rights) would be required to consolidate an entity for which there is evidence that it controls the entity according to that recommendation.

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*The size of a reporting entity's voting rights relative to the size of the other shareholder's voting rights*

53. Supporters of the 'dominant shareholder' view also believe that the size of a reporting entity's voting rights relative to the size of the other shareholder's voting rights matters when assessing control. Those staff believe that a reporting entity should hold more voting rights than any other party in order to meet the power element of the control definition (in the absence of other contractual arrangements). This is because power refers to a reporting entity's *ability* to direct the activities that matter. If another party holds more voting rights than the reporting entity, they do not think that it is possible for the reporting entity to have the *ability* to enforce its will because that other party could always outvote the reporting entity.
54. These staff also believe that a reporting entity's ability to direct the activities can be affected by the size of its voting rights relative to the size and dispersion of the voting rights held by other shareholders.
55. If the reporting entity could be outvoted by relatively few other shareholders, these staff believe that it is unlikely that the reporting entity has the ability to direct the activities of another entity. This is because, collectively, the other shareholders are *able to prevent the reporting entity from directing the activities of the other entity and could enforce their own will* as and when they choose to. In this situation, a 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.
56. In contrast, when the other shareholders are widely dispersed and could not easily organise themselves to vote together to outvote the reporting entity, the reporting entity is in a different position from one in which there is 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, and agree to vote together, in order to have that ability. Indeed, a widely dispersed group of shareholders would usually also have widely dispersed interests. Therefore, the staff think that very few actions of the reporting entity would be against the will

**Staff paper**

of most or all of the other shareholders, and could therefore be blocked without any active cooperation of those shareholders. The staff 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.

57. Therefore, the staff supporting the ‘dominant shareholder’ view would recommend that a reporting entity that holds less than half of the voting rights in another entity (and without other contractual rights relating to the activities of the entity) meets the power element of the control definition when all of the following are met:
- (a) the reporting entity holds significantly more voting rights than any other party;
  - (b) the other shareholders are not organised to vote together;
  - (c) the other shareholdings are widely dispersed; and
  - (d) there is evidence that the reporting entity has the ability to direct the activities of the entity that significantly affects the returns.
58. The appendix to this paper includes some examples illustrating the staff recommendations.

## Staff paper

**Question for the boards**

1. Do the boards agree that, in the absence of other arrangements, a reporting entity that holds more than half of the voting rights in an entity meets the power element of the control definition (paragraphs 17 and 18 of this paper)?
2. When a reporting entity (with less than half of the voting rights in an entity) that has the legal or contractual ability to direct the activities of the entity that significantly affect the returns, do the boards agree that the reporting entity meets the power element of the control definition (paragraphs 19 and 20 of this paper)?
3. When a reporting entity holds less than half of the voting rights in another entity (and without other contractual rights relating to the activities of the entity), do the boards think that the reporting entity would not meet the power element of the control definition without the contractual ability to direct the activities of the entity (the 'contractual rights' view)? If so, is there additional criterion or guidance that board members suggest to strengthen the concept?

If not, do the boards support a 'dominant shareholder' approach? If so, do the board members agree with the 'dominant shareholder' view proposed in this paper, such that that the reporting entity would meet the power element of the control definition if all of the following are met:

- (a) the reporting entity holds significantly more voting rights than any other party;
- (b) the other shareholders are not organised to vote together;
- (c) the other shareholdings are widely dispersed; and
- (d) there is evidence that the reporting entity has the ability to direct the activities of the entity that significantly affect the returns?

Appointing the majority of the members of the governing body would typically provide evidence of the ability to direct the activities. The indicators listed in paragraph 45 of this paper (either individually or collectively) could provide another form of evidence.

If not, what do you suggest and why?

## Staff paper

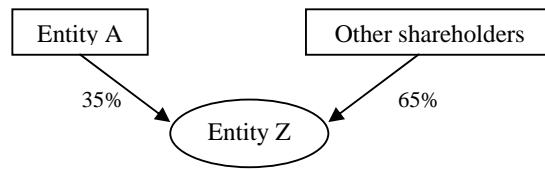
## APPENDIX

*Illustrative Examples*

59. In the examples below, none of the entities involved with Entity Z have contractual rights to control Entity Z. Therefore, the 'contractual rights' view would conclude that Entity Z should not be consolidated unless a reporting entity either held a majority of the voting interests or had the contractual ability (along with exposure to the variability of the returns) to direct the strategic and operating decisions of the other entity.

*Example 1*

60. Entity Z is a listed company with two thousand shareholders. Entity A has the largest shareholding, holding 35% of the voting rights. None of the remaining shareholders hold more than 2% of Entity Z; those shareholders are retail investors rather than institutional investors. The remaining shareholders have neither a formal nor informal agreement to vote together.
61. The dispersion of the remaining shareholdings is such that, at least, 400 shareholders would be required to vote together to be able to 'outvote' Entity A (ie the next largest holdings are held by 400 shareholders who collectively hold 36% of the voting rights of Entity Z). Shareholders voting at the shareholder meetings in recent years have held between 25% and 28% of the voting rights (when Entity A has not voted) and between 60% and 63% of the voting rights (when Entity A has voted).
62. Entity A did not vote at the last shareholders meeting, but did vote at the two previous shareholders meetings when it appointed all of the directors. A majority of those directors were the only nominations for reappointment at the most recent meeting. Although Entity A did not vote at the most recent shareholders meeting, a majority of the directors that it appointed in previous years were re-appointed by the other shareholders voting at the meeting, ie a majority of the current directors were originally appointed by Entity A.

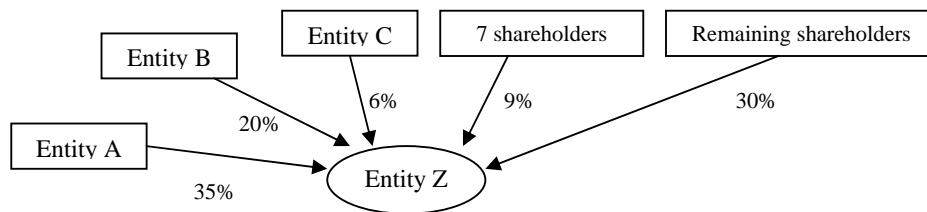
**Staff paper*****Application of the staff recommendation***

63. The 'dominant shareholder' view would conclude that Entity A controls Entity Z because its 35% holding is significantly more than the holdings of the other shareholders, and there is evidence that it has the ability to direct the activities of Entity Z that significantly affect the returns.
64. The 'contractual rights' view would conclude that Entity Z is not controlled by any party because neither Entity A nor any of the other parties involved with Entity Z has the contractual right to direct the activities of Entity Z that significantly affect the returns.

Staff paper

**Example 2**

65. Entity Z is a listed company with two thousand shareholders. Ten of those shareholders hold shareholdings that are significantly bigger than those held by the other shareholders as follows: Entity A holds 35% of the voting rights; Entity B holds 20%; Entity C holds 6%; seven other entities each hold between 1% and 3% of the voting rights in Entity Z. All of the remaining shareholders are retail investors with immaterial holdings.
66. The remaining shareholders have neither a formal nor informal agreement to act together. Entity A can be outvoted if the holders of the nine next largest shareholdings vote together (ie Entities B and C, plus the other seven entities mentioned above collectively hold 36% of the voting rights of Entity Z). Entity A has voted at all of the shareholders meetings in recent years. Entity A did not (alone) appoint the directors of Entity Z at the previous two meetings when those voting held 75% and 78% respectively (Entities B and C also attended those meetings). Entity A is not involved in the activities of Entity Z in any other way.



**Application of the staff recommendation**

67. The ‘dominant shareholder’ view would conclude that Entity A does not control Entity Z because it does not hold significantly more voting rights than Entity B, the other shareholders are not widely dispersed, nor is there evidence that Entity A has the ability to direct the activities of Entity Z that significantly affect the returns.



**Staff paper**

68. The 'contractual rights' view would also conclude that Entity Z is not controlled by any one party because none of the parties involved with Entity Z have the contractual right to direct the activities of Entity Z.