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| Project | **Consolidation** |
| Topic | **Options and convertible instruments** |

## Introduction

1. Paragraph 4 of ED 10 *Consolidated Financial Statements* defines control as the power to direct the activities of another entity to generate returns for the reporting entity. The purpose of this paper is to discuss and provide recommendations regarding the effect of options and convertible instruments on the overall control model being developed. Although this paper addresses options in isolation, it should be considered in conjunction with papers 3A, 3C, and 3D that also discuss the application of the control model.

2. At its October meeting, the IASB decided tentatively that a reporting entity should consider all of the rights that it holds and assess whether those rights are sufficient to give it the current ability to direct the activities of an entity that significantly affect the returns. Those rights could be voting rights, rights to obtain voting rights, rights within other contractual arrangements or a combination of these.

3. When an entity is controlled by voting rights and a reporting entity has rights to obtain voting rights (potential voting rights, eg options or convertible instruments), the questions that arise are:

(a) **can potential voting rights give a reporting entity the current ability to direct the activities of an entity that significantly affect the returns and, if so,**

(b) **in what situations do those potential voting rights give the reporting entity the current ability to direct those activities?**

4. This paper discusses, and proposes recommendations to answer, those questions. For simplicity, the paper often refers to options but the analysis that refers to options relates equally to any form of potential voting rights exercisable or convertible by the instrument holder.

## The requirements in IFRS and US GAAP

5. IAS 27 *Consolidated and Separate Financial Statements* states that the existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether an entity meets the power element of the control definition. The entity examines all facts and circumstances that affect potential voting rights, except the intention of management and the financial ability to exercise or convert such rights.

6. Examples included as guidance on implementing IAS 27 illustrate that the holder of currently exercisable options to obtain voting rights in an entity meets the power element of the control definition if the exercise of those options would result in the holder obtaining sufficient voting rights to control the entity.[1]

7. US GAAP does not refer to potential voting rights when assessing whether an entity has a controlling financial interest in another entity. Therefore potential voting rights are not considered when assessing whether one entity consolidates another.

[1] This is the case unless the potential voting rights lack economic substance (eg the exercise price is set in a manner that precludes exercise or conversion in any feasible scenario).

## The proposals in ED10 and in the 1999 FASB ED

### *The 1999 FASB ED*

8. The FASB issued an Exposure Draft in February 1999, *Consolidated Financial Statements: Purpose and Policy* (the 1999 ED). The 1999 ED stated that an entity is presumed to control another entity if it has the unilateral ability to (1) obtain a majority voting interest in the election of a corporation's governing body or (2) obtain a right to appoint a majority of the corporation's governing body through the present ownership of convertible securities or other rights that are currently exercisable at the option of the holder and the expected benefit from converting those securities or exercising that right exceeds its expected cost.

### *ED10*

9. Paragraph B13 of ED10 addressed options and convertible instruments as follows:

> 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.

10. Respondents to ED10 generally agreed that unexercised options, taken in conjunction with other facts and circumstances, might give a reporting entity the power to direct the activities of an entity. However many were confused by the application guidance. Many questioned how to apply the requirements in paragraph B13(a)—how would one know whether the decisions of the governing body were in accordance with the wishes of the reporting entity? Others noted that the situations described in paragraph B13(b) and (c) would lead to control for reasons other than the option or convertible instrument itself.

11. Participants at the IASB round tables in June 2009 had mixed views on potential voting rights. 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 believed that an option, in and of itself, does not give the holder power reflecting the 'future power' view expressed later in the paper. Others expressed the view that options almost always exist for a reason and, therefore, very often have a current effect on who, if anyone, controls the entity to which they relate.

## Discussions by the IASB to date

12. The IASB discussed potential voting rights at its July 2009 meeting, concluding that options to obtain voting rights could give the option holder the power to direct the activities of an entity. The staff and Board, however, were divided in their views on whether the options were required to be currently exercisable in order to give the holder power, and whether other factors should also be considered. Some Board members noted concerns about how to treat options that are exercisable only on particular days in each month or each year. Would or should those options be considered to be currently exercisable?

## Staff analysis

***The 'current power' view***

13. Some staff believe that the right to obtain voting rights (ie potential voting rights, such as those within an option or convertible instrument agreement) can give the holder the power to direct the activities of an entity if the options or convertible instruments, on exercise or conversion, give the holder voting rights sufficient to direct the activities of the entity that significantly affect the returns.

14. Therefore, for example, if a reporting entity holds options over 60 per cent of the voting rights of an entity (or alternatively holds 30 per cent of the voting rights and has options to obtain a further 30 per cent), the reporting entity has the power to direct the activities of the entity if the rights within the option agreement are substantive. Substantive rights to obtain voting rights give the holder the current ability to direct the activities of an entity in a similar manner to a passive majority shareholder (ie it can enforce its will on the party that it permits to hold what may look to be a controlling shareholding).

15. The staff supporting this view believe that the holder of options that are substantive is, in effect, in the same position as a passive majority shareholder. This is because the option holder has the current right to 'step in', exercise the option and subsequently exercise its voting power to direct the activities. Therefore, those staff would conclude that the holder of substantive potential voting rights meets the power element of the control definition because it has the *ability* to exercise power and direct the activities as and when it wishes to, regardless of whether it actually does.

16. Determining whether the potential voting rights are substantive requires judgement. Staff supporting the 'current power' view believe that it would be useful to provide the following guidance as factors to consider in determining whether potential voting rights are substantive:

    (a) Whether the rights are currently exercisable or convertible (see paragraphs 17-20 of this paper); and

(b) Whether the exercise or conversion price is such that exercise or conversion would benefit the holder of the rights (see paragraph 21 of this paper).

*Currently exercisable or convertible*

17. Staff supporting the ‘current power’ view think that potential voting rights would usually need to be currently exercisable in order for the holder to have the *current ability* to direct the activities of the entity that significantly affect the returns. Those staff reason that, for most entities that are controlled by voting rights, ongoing strategic decision making is required to direct the activities of the entity that significantly affect the returns. Without the current ability to obtain the voting rights, it is difficult to see how the holder of such rights could direct the activities of the entity as and when it wished to.

18. However, the entity may be established so that rights that are not currently exercisable give the holder the current ability to direct the activities that matter. For example, a reporting entity holds options over 60 per cent of the voting rights of an entity that are exercisable three months after the end of a reporting period. The reporting entity would *not* have the current ability to direct the activities that matter at the reporting date if the governing body or other parties can make decisions about the activities that significantly affect the returns during those months before the options become exercisable (and without the approval of the reporting entity).

19. In contrast, the reporting entity has the current ability to direct the activities that matter at the reporting date if, during that three month period, the reporting entity approves all decisions, or the governing body or another party is unable to make decisions, that could significantly affect the returns (eg the period until exercise is such that it is unlikely that significant decisions could be taken about the activities of the entity). In this case, the reporting entity has the right to make decisions about the activities of the entity as and when decision making is required.

20. This approach is consistent with the IASB’s decisions in October 2009 regarding rights that are available only when specified circumstances arise or

events happen.[2] This approach also provides a basis for assessing whether potential voting rights that are exercisable on particular days give the holder power.

*Exercise or conversion would benefit the holder of the rights*

21. Staff supporting the 'current power' view also think that a reporting entity should assess whether the terms and conditions of exercise or conversion are such that the reporting entity would benefit from exercise or conversion on the basis of current facts and circumstances. To be substantive, the reporting entity must have the ability to exercise its options if it chooses to do so—the reporting entity would, in effect, have that ability if exercising the options would benefit the reporting entity. In determining whether the holder of the options would benefit from exercising the options, consideration shall be given to both direct and indirect benefits. For example, a reporting entity may benefit from the exercise of an option that is out of the money by realising synergies or other returns that are not embodied in the option pricing. In contrast, a reporting entity may be unable to exercise an option that is in the money if the exercise price is such that the funding requirements are unrealistic.

*Consistency with the application of the control model*

22. Staff supporting the 'current power' view believe that the view is consistent with how the control model is applied in other situations. A majority shareholder

[2] The IASB concluded that rights that are available only when specified circumstances arise or events happen are protective rights in some situations and participating rights in other situations. They are participating rights in situations in which the day-to-day activities of an entity are administrative in nature and the reporting entity's rights give it the ability to direct the activities of the entity that significantly affect the returns. This is because the reporting entity has the right to make decisions about and, therefore, direct the activities of the entity as and when decision-making is required; the entity is set up so that decision-making is required only when specified circumstances arise or events happen. In such a situation, the so-called contingent rights are really the mechanism that ensures that the party with those rights has the current ability to direct the activities of the entity when those rights are needed. This is no different from an operating entity for which a majority shareholder exercises its power when it needs to.
A reporting entity has protective rights in situations in which the rights relate to circumstances and events that are expected to happen only in exceptional circumstances. In that situation, there are ongoing activities of the entity that significantly affect the returns, which the reporting entity has no current ability to direct. For example, a financial institution's ability to seize assets if a borrower fails to meet specified loan repayment conditions would usually be a protective right.

controls another 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 obtain its voting rights. In each case, the question is whether those steps are so significant that they prevent the reporting entity from having the current ability to direct the activities of another entity.

23. If the power element of the control definition was characterised as requiring either the legal or contractual 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. We describe power as the current *ability* to direct the activities of an entity that significantly affect the returns. Supporters of the 'current power' view believe that the holder of potential voting rights has that *ability* if the potential voting rights are substantive.

***The 'future power' view***

24. Other staff believe that options or convertible instruments should not be factored into determining whether a reporting entity has power over another entity unless the arrangement gives the reporting entity the current contractual or legal ability to control the other entity. In other words, if a reporting entity's legal ability or power does not currently exist but would (not does) exist if the options or other convertible interests were exercised, those staff believe that these arrangements represent contingent, not current, control. Instruments that are not exercised but give the holder the legal ability to direct the activities of another entity rarely, if ever, exist. Indeed, the reporting entity with the other arrangements may be able to influence the governing body of the entity for which it holds these arrangements, but influence through "threat" does not appear to be an appropriate basis for concluding that a reporting entity with these arrangements has control. Moreover, considering these arrangements requires practice to consider whether the option holder would exercise and convert its options into voting shares based on the economic status of the options.

25. However, the staff supporting this view believe that in situations in which an option is currently exercisable for a nominal amount and provides the option holder with "power", the option holder should consolidate. For example, assume Entity A holds 51 percent of Entity Z's voting stock while Entity B holds 49% with an option (currently exercisable) to purchase an additional 2% of Entity Z from Entity A. The strike price for the conversion is $1 per share while Entity Z's shares have a market value of $50 per share. Staff supporting this view would conclude that Entity B should consolidate Entity Z and that Entity A is an agent for Entity B. In the situation provided in this paragraph, the staff supporting this view believe that the option is analogous to a substantive kick-out right held by a single party (Entity B).

26. In the absence of explicit legal rights obtained through the instruments that currently allow the instrument holder to direct the activities of another entity that impact the reporting entity's returns (that is, the ability before the instruments are converted), the staff supporting the 'future power' view believe that requiring consideration of all facts and circumstances, including economics, is simply not operational.

27. Additionally, those staff believe that, regardless of whether an option is currently exercisable and economically in the money (except for the situation described in paragraph 25 of this paper), until the option is exercised (in the absence of other rights that give the holder power), the holder does not "currently" control the other entity. Moreover, those staff do not believe that the reporting entity with the current legal ability to direct the activities of the other entity (not considering options not yet exercised) is acting on behalf of the option holder. Considering the economics of their convertible instruments also could result in pervasive consolidation/deconsolidation by the convertible instrument holder because its ability to direct may change over time or be based on the economics of its arrangements.

28. Consequently, staff supporting the 'future power' view propose that potential voting rights not be considered in determining whether a reporting entity controls another entity until the instruments are exercised or converted, unless the instruments explicitly provide the holder with the legal ability to have power

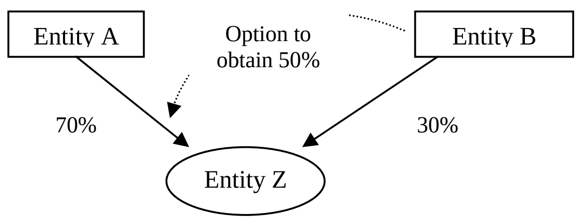
over the entity at any given time, regardless of whether the holder chooses to exercise this power.

| Questions for the boards |
| --- |
| 1. Do the boards think that potential voting rights should not be considered when determining whether a reporting entity controls another entity until the instrument is exercised or converted, except in situations in which the instruments are currently exercisable for a nominal amount (the 'future power' view)?<br><br>2. Alternatively, do the boards think that a reporting entity that has substantive potential voting rights meets the power element of the control definition if, on exercise or conversion, the holder would have voting rights that are sufficient to give it the ability to direct the activities of an entity that significantly affect the returns (the 'current power' view)?<br><br>If so, do you agree that when determining whether potential voting rights are substantive, a reporting entity should consider:<br>(a) whether the rights are currently exercisable or convertible, and<br>(b) whether the exercise or conversion price is such that exercise or conversion would benefit the reporting entity?<br><br>If not, what would you propose and why? |

## APPENDIX

### *Example 1*

29. Entity Z is not a listed company. It is owned by two shareholders—Entity A holds 70% of the voting rights, which gives it the right to appoint 7 members of the board of directors; Entity B owns 30% of the voting rights, which gives it the right to appoint 3 members of the board of directors. Entity B also holds an option to acquire 50% of the voting rights held by Entity A. The option is exercisable at any time for little consideration and there are no other factors that would prevent Entity B from exercising the options. All strategic decisions about the activities of Entity Z require the approval of 6 directors.



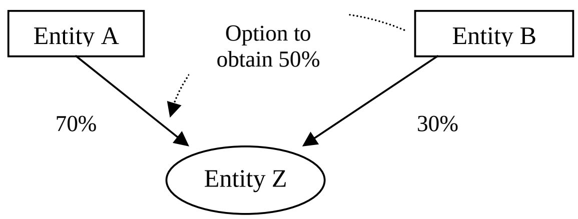

#### *Application of the staff recommendations*

30. The ‘current power’ view would conclude that Entity B controls Entity Z. Entity B has the current ability to enforce its will in directing the activities of Entity Z because it has the current ability to step in, exercise the option and exert its will as and when it needs to.

31. The ‘future power’ view would also conclude that Entity B controls as the exercise price is currently exercisable for a nominal amount and no barriers exist to prevent Entity B from exercising its rights.

## Example 2

32. Same fact pattern as example 1 except that the option held by Entity B is exercisable one month after the end of the reporting period. An assessment of the activities of Entity Z identifies that the one month period until the options become exercisable is too short to make and implement any strategic decisions about those activities.



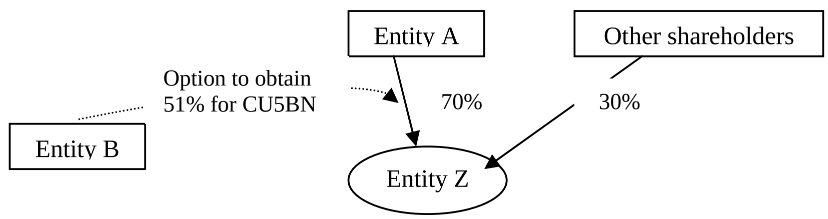

### *Application of the staff recommendations*

33. The 'current power' view would conclude that Entity B controls Entity Z. Although Entity B's option is only exercisable one month after the end of the reporting period, strategic decisions about the activities of Entity Z cannot be taken before the options become exercisable. Therefore Entity B already has the ability to enforce its will in directing the activities of Entity Z that significantly affect the returns.

34. The 'future power' view would conclude that Entity A controls Entity Z until Entity B exercises the options. Entity A has appointed 7 of the board members and currently controls the entity. In the fact pattern, Entity B, through its options, does not have the explicit legal right to direct the activities of Entity Z and would not have legal power until it exercised its options. Moreover, as Entity B cannot be involved in the strategic decisions related to the activities of Entity Z until it exercises its option, its control is deemed to be contingent, not current.

### *Example 3*

35. Entity Z is not a listed company. Entity A holds 70% of the voting rights; the remaining 30% is held by a number of unrelated parties. Entity B (who is not a shareholder) holds an option to acquire 51% of the voting rights held by Entity A. The option is exercisable at any time for CU5 billion, which is significantly more than the value of 51% of Entity Z today, and more than its expected value at any time in the future.




#### *Application of the staff recommendations*

36. Both staff views conclude that Entity A controls Entity Z. Although Entity B holds a currently exercisable option to acquire 51% of the voting rights of Entity Z, the exercise price that is deeply out of the money creates a barrier to exercising the option—Entity B would not benefit from the exercise of the option on the basis of current facts and circumstances. Therefore, the option is not considered to be substantive according to the ‘current power’ view.

37. Staff supporting the ’future power’ view agree that Entity A controls Entity Z but also believe that, regardless of the economic status of Entity Z (unless the shares are currently exercisable for a nominal amount), Entity A would control until Entity B exercised its options (absent any contractual rights attached to the options that provide Entity B with the legal right to direct).