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Project	<b>Consolidation</b>
Topic	<b>The control model—follow-up questions regarding voting rights</b>

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## Introduction

1. Agenda paper 8A sets out four different views of power. We have asked you to indicate which of those views you support. Your responses to the questions in this paper will be considered in the context of the view of power in agenda paper 8A that you support.
2. Although the boards made tentative decisions regarding voting rights and potential voting rights (eg options and convertible instruments) at the January 2010 meeting, this paper asks a couple of questions regarding both of these issues to clarify those tentative decisions taking into account the view of power that you support.

## Demonstration of power

### ***Background regarding the demonstration of power (linking to the four views set out in agenda paper 8A)***

3. The exercise or demonstration of power is *not* required according to the ‘ability to’ view in order to conclude that a reporting entity that holds less than half of the voting rights has power. However we would propose that, if the assessment of power is difficult (eg perhaps when the reporting entity holds a lower percentage of voting rights), indicators of power would be used to help with that assessment. Those indicators would be similar to the actions and factors listed

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in paragraphs 7 and 8 of this paper, and similar to the indicators of power listed in paragraph B9 of ED10 *Consolidated Financial Statements*.

4. The demonstration of power is not relevant according to the ‘contractual rights’ view in that a reporting entity with less than half of the voting rights in an entity does not have power unless it has rights within other contractual arrangements that give it the contractual right to direct the activities.
5. Both the ‘ability to’ view—with evidence and the ‘demonstration of power’ view require the demonstration of a reporting entity’s power when the reporting entity does not have the legal or contractual ability to direct the activities of another entity (ie when the reporting entity holds less than half of the voting rights in an entity). In the context of entities controlling by voting rights, the difference between the ‘ability to’ view—with evidence and the ‘demonstration of power’ view results from the fact that the ‘ability to’ view—with evidence would also require that the reporting entity holds significantly more voting rights than any other party, and the other shareholdings would be widely dispersed.
6. Support for either of these views requires that we develop guidance to help determine when a reporting entity with less than half of the voting rights in an entity has demonstrated that it directs the activities. As noted above, we would also recommend that the ‘ability to’ view include indicators of power as part of the application guidance in the consolidation standard. Those indicators, however, would be used in a different way according to the ‘ability to’ view—they would be used to assist when assessing whether a reporting entity with less than half of the voting rights has power over another entity in situations in which the assessment is difficult. According to the ‘ability to’ view—with evidence and the ‘demonstration of power’ view, the actions and factors would be part of the requirements in order to conclude that a reporting entity with less than half of the voting rights in an entity has power.

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7. The following are a list of actions and factors that we believe should be considered when assessing whether a reporting entity with less than half of the voting rights has demonstrated that it directs the activities of an entity that significantly affect the returns. Consideration should be given, but not limited to, these actions and factors. Depending on the circumstances, power might be demonstrated by a single action or factor or a combination thereof:

**Actions**

- (a) The reporting entity has determined the entity's strategic operating and financing policies.
- (b) The reporting entity has approved or appointed the entity's key management personnel.
- (c) The reporting entity has initiated, approved or vetoed significant transactions proposed by the entity.

**Factors**

- (d) The majority of the governing body's members are related parties of the reporting entity.
- (e) The majority of the entity's key management personnel are current or previous employees of the reporting entity.
- (f) The entity's economic performance is dependent on the reporting entity, including the following:
  - (i) The entity is dependent on the reporting entity for funding its operations.
  - (ii) The reporting entity guarantees a significant portion of the entity's obligations.
  - (iii) The entity is dependent on the reporting entity for critical services, supplies or raw materials.
  - (iv) The entity is dependent on the reporting entity for key management personnel such as in situations in which the

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reporting entity's personnel have specialised knowledge of the entity's operations.

- (v) The reporting entity controls assets that are critical to the entity's operations.
- (g) Contractual arrangements (other than those that give the reporting entity the ability to direct the activities that significantly affect the returns) that require substantially all of the entity's activities to involve or be conducted on behalf of the reporting entity.

*Nominating or appointing the governing body*

8. Some staff believe that a reporting entity with less than half of the voting rights in an entity can demonstrate its power if it has nominated or appointed a majority of that other entity's governing body. This situation would arise when a sufficient number of other vote holders do not exercise their voting power and, thus, the reporting entity is able to nominate or appoint a majority of the members of the governing body. Therefore those staff would add the following actions to the list included in paragraph 7 above:
  - (a) The reporting entity has appointed the majority of the members of the governing body, which makes strategic decision about the activities of the entity.
  - (b) The reporting entity has dominated the process of appointing the governing body, which makes the strategic decisions about the activities of the entity. 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 rights.
    - (ii) Appointing members to fill vacancies on the entity's governing body until the next election.
9. Other staff do not believe that nominating or appointing a majority of the members of another entity's governing body demonstrates power when the reporting entity is in that position because of the inaction of other vote holders.

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**Questions 1 and 2 for the boards**

1. Do the board members agree that the list of actions and factors listed in paragraph 7 of this paper either individually or in combination can demonstrate power (the 'ability to' view—with evidence; the 'demonstration of power' view), or would be an indicator of power (the 'ability to' view)? If not, which actions or factors would you remove and are there others that you would add?

2. Do you think that:

(a) a reporting entity can demonstrate that it has power by nominating or appointing a majority of the members of the governing body of another entity (the 'ability to' view—with evidence; the 'demonstration of power' view), or  
 (b) nominating or appointing a majority of the members of the governing body of another entity is an indicator of power?

If yes, do you agree to add the actions listed in paragraph 8 of this paper to the list of actions that should or could be considered?

**Determining when potential voting rights are substantive**

10. At the January 2010 joint board meeting, the boards tentatively decided that a reporting entity should consider potential voting rights (eg options or convertible instruments) when assessing whether it has the power through voting rights to direct the activities of an entity that significantly affect the returns. The discussions at that meeting indicated that the board members believe that it would be inappropriate to conclude that potential voting rights always give the holder power, but equally inappropriate to conclude that potential voting rights never give the holder power.<sup>1</sup> The difficulty is to identify in which situations such instruments give the holder power. The staff view is that some guidance should be included to help assess when this would be the case.
11. We believe that potential voting rights can give the holder the *contractual ability* to direct the activities that significantly affect the returns, if the rights are substantive and on exercise or conversion, would give the holder voting rights sufficient to direct those activities. The holder has the current right to 'step in',

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<sup>1</sup> Note: supporters of the 'contractual rights' view would conclude that potential voting rights should not be considered when assessing control of an entity until they are exercised. The tentative decision of the boards in January regarding potential voting rights followed from the tentative decision by the majority of each Board to reject the 'contractual rights' view.

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exercise or convert the instrument and subsequently exercise its voting power to direct the activities. Therefore, the holder of substantive potential voting rights can meet the power element of the control definition by having the *contractual ability* to exercise power and direct the activities as and when it wishes to, regardless of whether it actually does.

12. This is consistent with how the ‘ability to’ view, the ‘ability to’—with evidence view and the ‘demonstration of power’ view is applied in other situations. A majority shareholder 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 and exercise power. In each case, the question is whether those steps are so significant that they create barriers that prevent the reporting entity from having the current ability to direct the activities of another entity.
13. Therefore the staff believe that it is consistent with the ‘ability to’ view, the ‘ability to’—with evidence view and the ‘demonstration of power’ view to conclude that substantive potential voting rights should be considered when assessing control of an entity (demonstrated in examples 7-10 in the table in agenda paper 8A).
14. However we acknowledge that it can be difficult to assess when potential voting rights are substantive and should be considered when assessing control.
15. For any right (whether that be a voting right, a kick-out right or any other participating right) to give the holder power, that right must be substantive. We use the word ‘substantive’ to indicate that the right, in effect, gives the holder the current ability to direct the activities that significantly affect the returns. To have the current ability to direct, the terms and conditions must be such that there are no barriers that would prevent the holder from exercising the right.
16. All staff agree that, to be substantive, potential voting rights would usually need to be currently exercisable in order to give the holder the current ability to direct the activities of an entity. For most entities that are controlled by voting rights, ongoing strategic decision making is required to direct the activities of the entity

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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.<sup>2</sup>

17. The question then arises as to whether the exercise price should be a factor to consider when assessing whether a potential voting right is substantive.

18. Again, all staff agree on the following:

- (a) If potential voting rights are currently exercisable or convertible for a nominal amount, those rights would be substantive in the absence of other factors. A nominal exercise price would not create a barrier that would prevent the holder from exercising the right.
- (b) If potential voting rights are exercisable or convertible for a price that is expected to be considerably more than the value of the voting rights in any feasible scenario, those rights would not be substantive. Such an exercise price would create a barrier that would prevent the holder from exercising the right.

19. But when the exercise price is somewhere between nominal and being deeply out-of-the-money in any feasible scenario, when are potential voting rights substantive?

20. The staff thinks that there are three approaches that the boards could take:

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<sup>2</sup> Extract from January 2010 agenda paper 3B: 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 two 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).

In contrast, the reporting entity has the current ability to direct the activities that matter at the reporting date if, during that two 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.

This approach is consistent with the boards' decisions regarding rights that are available only when specified circumstances arise or events happen. This approach also provides a basis for assessing whether potential voting rights that are exercisable on particular days give the holder power.

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- (a) **View A:** Apply judgement to assess whether potential voting rights are substantive by considering whether there are barriers that would prevent the holder from exercising its rights on the basis of current facts and circumstances (see paragraphs 21-24 below).
- (b) **View B:** Conclude that potential voting rights should be considered as long as they are currently exercisable or convertible (the IAS 27 approach—see paragraphs 25-27 below).
- (c) **View C:** Conclude that potential voting rights should be considered only when they are currently exercisable or convertible for a nominal amount (see paragraphs 28-30 below).

**View A**

- 21. Some staff believe that it is consistent with other aspects of the control model being developed to say that potential voting rights would give the holder power when those potential voting rights are substantive. Those staff would propose to include guidance:
  - (a) regarding the potential voting rights being currently exercisable or convertible, similar to that set out in paragraph 16 of this paper.
  - (b) to say that a reporting entity should consider all facts and circumstances in determining whether there are any barriers to exercising the rights that, in effect, mean that the holder does not have the current ability to direct the activities of an entity (this would be the same guidance that would apply to all participating rights). An example of such a barrier would be an exercise or conversion price that would prevent the holder from exercising its rights. However the exercise or conversion price would not be the only factor to consider.
- 22. Those staff would *not* propose to add further guidance but to leave the assessment as to whether a particular exercise or conversion price would prevent the holder from exercising its rights to judgement. For example, those staff do not think that it would be appropriate to include guidance that would draw the line at being in or out of the money.



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23. The main advantage of such an approach is that it is consistent with the other aspects of the control model—a reporting entity would use the same guidance to assess whether any participating right is substantive, whether that right is a voting right, a potential voting right, or a right obtained within other contractual arrangements.
24. The main disadvantage of such an approach is that it would require more judgement.

**View B**

25. If the boards do not support view A, those staff supporting view A would recommend view B—the IAS 27 approach that considers all potential voting rights that are currently exercisable or convertible unless the potential voting rights lack economic substance (eg the exercise or conversion price is set in a manner that precludes exercise or conversion in any feasible scenario).
26. IAS 27 states that the existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether a reporting entity meets the power element of the control definition. The reporting 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.
27. 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.<sup>3</sup>

**View C**

28. Other staff recommend view C—that a reporting entity considers potential voting rights only if they are currently exercisable or convertible for a nominal

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<sup>3</sup> 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).

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amount. They would consider any financial outflow that is more than nominal to be a barrier to exercising the right.

29. The main advantage of views B and C is that they require less judgement when assessing whether potential voting rights affect the assessment of control of an entity.
30. The main disadvantage is that, for each of these views, there may be situations when a reporting entity with potential voting rights will either be required to consolidate or not to consolidate when a consideration of all facts and circumstances might lead to a different conclusion. Some would also argue that view C would appear to be less consistent with the 'ability to' views of power.

**Question 3 for the boards**

Do you think that, when assessing control of an entity controlled by voting rights, potential voting rights should be considered:

- (a) when they are substantive, ie when the terms and conditions do not create a barrier that would prevent the holder from exercising the rights (view A),
- (b) when they are currently exercisable or convertible (view B), or
- (c) when they are currently exercisable or convertible for a nominal amount (view C)?