Project **Consolidation and joint arrangements**

Topic **Sweep Issue: Potential voting rights when assessing significant influence**

Introduction

1. When reviewing the preballot draft of IAS 28 *Investments in Associates and Joint Ventures*, some Board members questioned whether the wording of paragraphs 8 and 9 of IAS 28 regarding potential voting rights when assessing significant influence should be changed to be consistent with IFRS 10.

2. This paper discusses whether changes should be made to those paragraphs of IAS 28 (paragraphs 8 and 9 of IAS 28 are reproduced in paragraph 4 of the paper).

Background and staff analysis

3. Significant influence is defined in IAS 28 *Investments in Associates* as 'the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies'. The Board did not discuss, nor does it plan to change, that definition of significant influence as part of its consolidation or joint arrangements projects.

4. IAS 28 includes the following requirements regarding the consideration of potential voting rights when assessing significant influence:

    8 An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity

additional voting power or reduce another party's voting power over the financial and operating policies of another entity (ie potential voting rights). The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, are considered when assessing whether an entity has significant influence. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

9 In assessing whether potential voting rights contribute to significant influence, the entity examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential rights, except the intention of management and the financial ability to exercise or convert.

5. The wording of paragraphs 8 and 9 of IAS 28 is similar to that included in paragraphs 14 and 15 of IAS 27 *Consolidated and Separate Financial Statements* regarding the consideration of potential voting rights when assessing control. However, it is different from the wording to be included in IFRS 10 *Consolidated Financial Statements*. This is because the Board has changed the definition of control in its consolidation project and, consequently, changed the requirements regarding the consideration of potential voting rights when assessing control. The appendix to this paper includes the definition of control and the requirements regarding potential voting rights included in the preballot draft of IFRS 10 [*please note: the appendix has been omitted from the observer note*].

6. We believe that there are two ways to look at this issue:

   (a) View A: do not change the requirements in IAS 28 regarding significant influence at this time (paragraphs 7-9 of the paper).

   (b) View B: align the requirements in IAS 28 regarding potential voting rights when assessing significant influence with those in IFRS 10 (paragraphs 10-14 of the paper).

View A: do not change the requirements in IAS 28 regarding significant influence at this time

7. IFRS 10 redefines control as set out in the appendix to this paper. To help assess whether an investor controls an investee, IFRS 10 has amended the requirements in IAS 27 regarding potential voting rights (also included in the appendix to the paper) and introduces requirements and guidance on all of the following topics that are not specifically addressed in IAS 27:

   (a) Assessing power when voting rights do not have a significant effect on an investee's returns.

   (b) Considering the purpose and design of an investee.

   (c) Substantive rights that give an investor power.

   (d) Substantive rights held by others that can prevent an investor from controlling an investee.

   (e) Protective rights.

   (f) Assessing power when two or more investors each have rights that provide the unilateral ability to direct different relevant activities.

   (g) Power without holding a majority of the voting rights of an investee.

   (h) Evidence and indicators of power.

   (i) Power over specified assets.

   (j) Delegated power (ie assessing whether a decision-maker is an agent or a principal).

   (k) De facto agents.

8. Because the definition of significant influence in IAS 28 has been built on the definition of control in IAS 27 ('significant influence' is the power to participate in the financial and operating policy decisions of an entity; 'control' in IAS 27 refers to the power to govern the financial and operating policies of an entity), the changes made to the definition and assessment of control in IFRS 10 raises the question of whether and how those changes affect the assessment of significant influence. For example, is the assessment of significant influence

changed as a result of the changes to how an investor assesses control when voting rights do not have a significant effect on an investee's returns? Do rights have to be substantive to give an investor significant influence? Could protective rights give an investor significant influence? Should rights held by de facto agents be considered when assessing significant influence? Can an investor have significant influence over specified assets? etc.

9. Those supporting **view A** believe that it would be appropriate to relook at IAS 28 to determine whether and how the definition and assessment of significant influence should be changed in the light of changes made to the definition and assessment of control. However, this is outside the scope of the consolidation and joint arrangements projects. If this is to be done, they believe that it should be done as part of a separate project that addresses all aspects of IAS 28 that are considered to be in need of review. Constituents will have an opportunity to comment on whether the Board should add a project on IAS 28 in response to the public consultation on the Board's technical agenda that will commence no later than 30 June 2011.

View B: align the requirements in IAS 28 regarding potential voting rights when assessing significant influence with those in IFRS 10

10. Without any change to paragraphs 8 and 9 of IAS 28 regarding potential voting rights (as set out in paragraph 4 of this paper), the effect of potential voting rights when assessing control could be different from their effect when assessing significant influence. For example, when assessing significant influence, potential voting rights are considered only when they are currently exercisable but an investor's financial ability to exercise or convert is not considered. When assessing control, an investor must determine whether potential voting rights are substantive, which includes an assessment of an investor's ability to exercise or convert potential voting rights. Additionally, an investor should consider whether the potential voting rights give it the current ability to direct the relevant activities when decisions about those activities need to be made. Thus, potential voting rights are sometimes considered when assessing control even though the rights are not currently exercisable.

11. Supporters of **view B** believe that it is confusing to treat potential voting rights differently when assessing significant influence than when assessing control. Two constituents who provided fatal flaw comments on a draft of IAS 28 (as revised in 2011) suggested that the wording should be consistent. They would, therefore, recommend changing the requirements in paragraphs 8 and 9 of IAS 28 to be more closely aligned with the requirements in IFRS 10.

12. An essential piece of the requirements in IFRS 10 regarding potential voting rights is the guidance to help determine whether rights are substantive. If the Board were to agree with **view B**, we think that it would be necessary to include some guidance on determining whether potential voting rights are substantive for the purposes of IAS 28.

13. It is worth noting that ED 10 *Consolidated Financial Statements* proposed a consequential amendment to paragraph 9 of IAS 28 that would more closely align the wording of IAS 28 with that proposed in ED 10 regarding potential voting rights as follows. 'In assessing ~~whether potential voting rights contribute to~~ significant influence, the 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 participate in the strategic operating and financing policy decisions of an entity. ~~examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential rights, except the intention of management and the financial ability to exercise or convert.~~'

14. However ED 10 did not propose a change to paragraph 8 of IAS 28 (as set out in paragraph 4 of this paper). Therefore the consequential amendment proposed was mainly a change of wording rather than a change in how to consider potential voting rights when assessing significant influence. Because the Board is not changing the definition of significant influence as part of the consolidation project, the preballot draft of IFRS 10 does not include a consequential amendment to IAS 28 in this respect.

Staff recommendation

15. The staff support **view A** because we do not think that it would be helpful to change one aspect of the assessment of significant influence (ie the requirements relating to potential voting rights) in isolation at this time, without also at least addressing the potential effects on IAS 28 of all of the other changes made to control as part of the consolidation project. We think that the changes to the requirements of IAS 28 that would be required according to **view B** could have broader implications than simply the consideration of potential voting rights when assessing significant influence (for example, the inclusion of guidance regarding determining whether rights are substantive). We think that changing the assessment of significant influence in this way goes beyond the scope of the consolidation and joint arrangements projects. The basis for conclusions to IAS 28 and IFRS 10 would, however, acknowledge the differing treatment of potential voting rights when assessing significant influence and control, and explain why the requirements of IAS 28 have not been changed at this time.

16. Question 12 of the Invitation to Comment on ED 10 asked whether the Board should consider the definition of significant influence and the use of the equity method in IAS 28 with a view to developing proposals as part of a separate project. Most of those responding to question 12 agreed that the Board should consider the requirements in IAS 28 as part of a separate project—many requesting changes or clarifications to the equity method, others noting the interaction between the definition of control and significant influence. Additionally and as noted in paragraph 9, constituents will also have an opportunity to ask the Board to add IAS 28 to its technical agenda as part of the public consultation that will be undertaken later in 2011. In our view, the Board should not make one small change to IAS 28 at this time, in advance of a more comprehensive review of IAS 28, should such a project be added to the Board's post-2011 technical agenda.

Question for the Board
Does the Board agree that the requirements in IAS 28 regarding potential voting rights when assessing significant influence should <u>not</u> be changed at this time?

APPENDIX—extracts from the preballot draft of IFRS 10

[Omitted from observer note