HONG KONG SOCIETY OF ACCOUNTANTS

Financial Accounting Standards Committee

Urgent Issues & Interpretations Sub-Committee

Interpretation 18 Consolidation and Equity Method - Potential Voting Rights and Allocation of Ownership Interests

Interpretations are authoritative guidance on the application of Statements of Standard Accounting Practice with which enterprises should comply if their financial statements purport to give a true and fair view. Unless indicated otherwise, Interpretations have the same status as the background material and implementation guidance contained in Statements of Standard Accounting Practice. Interpretations are not intended to apply to immaterial items.

References: SSAP 32 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*

SSAP 10 *Accounting for Investments in Associates*

ISSUES

1. An enterprise 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 enterprise voting power or reduce another party's voting power over the financial and operating policies of another enterprise (potential voting rights).

2. The issues are:

   (a) when assessing whether an enterprise controls or significantly influences another enterprise according to SSAP 32 and SSAP 10 respectively,

      (i) whether the existence and effect of potential voting rights should be considered, in addition to the factors described in SSAP 32 paragraph 14 and SSAP 10 paragraphs 3 and 4; and

      (ii) if so, whether any other facts and circumstances related to potential voting rights should be assessed;

   (b) whether the proportion allocated to the parent and minority interests in preparing consolidated financial statements under SSAP 32, and the proportion allocated to an investor that accounts for its investment in an associate using the equity method under SSAP 10, should be determined based on present ownership interests or ownership interests that would be held if the potential voting rights were exercised or converted; and

   (c) the appropriate accounting treatment for potential voting rights until they are exercised or expire.

CONCLUSIONS[1]

3. The existence and effect of potential voting rights that are presently (i.e., currently) exercisable or presently convertible should be considered, in addition to the factors described in SSAP 32 paragraph 14 and SSAP 10 paragraphs 3 and 4, when assessing whether an enterprise controls (as defined in SSAP 32 paragraph 8) or significantly influences (as defined in SSAP 10 paragraph 2) another enterprise. All potential voting rights should be considered, including potential voting rights held by other enterprises. Potential voting rights are not presently exercisable or presently convertible when, for example, they cannot be exercised or converted until a future date or upon the occurrence of a future event.

4. All facts and circumstances that affect potential voting rights considered in accordance with paragraph 3 of this Interpretation should be examined, except the intention of management and the financial capability to exercise or convert. Other facts that should be considered include the terms of exercise of the potential voting rights and possible linked transactions. (Appendix A provides illustrations of application of this Interpretation.)

5. The proportion allocated to the parent and minority interests in preparing consolidated financial statements under SSAP 32, and the proportion allocated to an investor that accounts for its investment using the equity method under SSAP 10, should be determined based solely on present ownership interests. An enterprise may, in substance, have a present ownership interest when for example, it sells and simultaneously agrees to repurchase, but does not lose control of, access to economic benefits associated with an ownership interest. In this circumstance, the proportion allocated should be determined taking into account the eventual exercise of potential voting rights and other derivatives that, in substance, presently give access to the economic benefits associated with an ownership interest. (Appendix B provides illustrations of application of this Interpretation.)

6. When applying the consolidation and the equity method of accounting, instruments containing potential voting rights should be accounted for as part of the investment in a subsidiary and the investment in an associate respectively only when the proportion of ownership interests is allocated by taking into account the eventual exercise of those potential voting rights in accordance with paragraph 5 of this Interpretation.[2]

BASIS FOR CONCLUSIONS

7. SSAP 32 paragraph 8 defines control as the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities. SSAP 10 paragraph 2 defines significant influence as the power to participate in the financial and operating policy decisions of the investee but not to control those policies. In these contexts, power refers to a capability of doing or effecting something. Consequently, an enterprise has control or significant influence when it presently has the capability to exercise that power, regardless of whether control or significant influence is actively demonstrated or passive in nature. Potential voting rights that are presently exercisable or presently convertible, and are held by an enterprise, provide this capability. The capability to exercise power does not exist when potential voting rights lack economic substance (e.g., the exercise price is deliberately set so high as to have only a remote possibility of exercise or conversion). Consequently, potential voting rights are considered when, in substance, they provide the capability to exercise power.

[1] As explained in SSAP 32 paragraph 4, a Hong Kong incorporated company may not consolidate a company that does not meet the definition of a subsidiary in the Companies Ordinance. SSAP 32 paragraphs 27, 28 and 46 specify alternative requirements in such cases.

[2] In accordance with SSAP 1, Presentation of Financial Statements, paragraph 23, management could consider IAS 39 "Financial Instruments: Recognition and Measurement" when accounting for the instruments containing potential voting rights in circumstances other than those described in paragraph 6 above.

8. Control and significant influence also arise in the circumstances described in SSAP 32 paragraph 14 and SSAP 10 paragraphs 3 and 4 respectively, which include consideration of the relative ownership of voting rights. Potential voting rights such as share call options and convertible debt are capable of effecting a change in an enterprise's voting power over another enterprise - if the potential voting rights are exercised or converted, then the relative ownership of the ordinary shares carrying voting rights changes. Consequently, the existence of control (the definition of which permits only one enterprise to be the parent of another enterprise) and significant influence is determined only after assessing all the factors described in SSAP 32 paragraph 14 and SSAP 10 paragraphs 3 and 4 respectively, and considering the existence and effect of potential voting rights. In addition, all facts and circumstances that affect potential voting rights are examined, except the intention of management and the financial capability to exercise or convert. The intention of management does not affect the existence of power. The financial capability of an enterprise is difficult to assess.

9. An enterprise may consider that, prima facie, it controls or significantly influences another enterprise after considering the potential voting rights that it can presently exercise or presently convert. However, the enterprise may not control or significantly influence the other enterprise when other potential voting rights held by other parties are also presently exercisable or presently convertible. Consequently, an enterprise considers all potential voting rights held by itself and other parties that are presently exercisable or presently convertible when determining whether it controls or significantly influences another enterprise. For example, all share call options are considered, whether held by the enterprise or another party. Further, the definition of control in SSAP 32 paragraph 8 permits only one enterprise to be the parent of another enterprise. Therefore, when two or more enterprises each hold significant voting rights, both actual and potential, the factors in SSAP 32 paragraph 14 are reassessed to determine which enterprise might be the parent.

10. Minority interests are defined as the part of the net results of operations of a subsidiary attributable to interests which are not owned by the parent. When applying consolidation procedures according to SSAP 32, the minority interests in the net income of consolidated subsidiaries for the reporting period are adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent. When applying the equity method of accounting according to SSAP 10, the carrying amount of the investment is increased or decreased to recognise the investor's share of the profits or losses of the investee after the date of acquisition. The carrying amount of the investment is also adjusted for alterations in the investor's proportionate interest in the investee arising from changes in the investee's equity that have not been included in the income statement. In these circumstances, only present ownership interests are used, because potential voting rights do not currently entitle an investor to a different share of net assets. In some circumstances an enterprise has, in substance, a present ownership as a result of a transaction that gives it access to the economic benefits associated with an ownership interest. In such circumstances, the proportion allocated is determined taking into account the eventual exercise of those potential voting rights and other derivatives that currently give the enterprise access to the economic benefits.

11. When instruments containing potential voting rights, in substance, presently give access to the economic benefits associated with an ownership interest, as described in paragraph 5 of this Interpretation, the investment is accounted for using the consolidation or equity method of accounting.[3]

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[3] In accordance with SSAP 1 paragraph 23, management could consider IAS 39 "Financial Instruments: Recognition and Measurement" when accounting for the instruments containing potential voting rights in the case where, in substance, they do not presently give access to the economic benefits associated with an ownership interest as described in paragraph 5 of this Interpretation.

Appendices

The purpose of these appendices is illustrative only and does not form part of the Interpretation. The purpose of these appendices is to illustrate the application of the Interpretation to assist in clarifying its meaning.

APPENDIX A: CONSIDERATION OF POTENTIAL VOTING RIGHTS

The Interpretation requires consideration of the existence and effect of all potential voting rights that are presently exercisable or presently convertible. It also requires all facts and circumstances that affect potential voting rights to be examined, except the intention of management and the financial capability to exercise or convert potential voting rights.

The purpose of this Appendix is to demonstrate how potential voting rights are considered, not to provide the reasons for concluding whether an enterprise has significant influence or control. Each example in this Appendix demonstrates one aspect of a potential voting right - all aspects are considered when applying the Interpretation. The existence of control and significant influence can only be determined after assessing the many other factors described in SSAP 32 paragraph 14 and SSAP 10 paragraphs 3 and 4 respectively. For the sole purpose of this Appendix, these other factors are presumed to not affect the determination (except for example 4), even though they may when assessed.

<u>Example 1: Options are out-of-the-money</u>

1. Enterprises A and B own 80% and 20% respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Enterprise C. Enterprise A sells one half of its interest to Enterprise D and buys call options from Enterprise D that are exercisable at any time at a premium to the market price at issuance, and if exercised would give Enterprise A its original 80% ownership interest and voting rights. The exercise price is not deliberately set so high that the possibility of exercise is remote.

2. Though the options are out-of-the-money, they are presently exercisable and give Enterprise A the power to continue to set the operating and financial policies of Enterprise C, because Enterprise A could currently exercise its options. The existence of the potential voting rights, as well as the other factors described in SSAP 32 paragraph 14, are considered and it is determined that Enterprise A controls Enterprise C.

<u>Example 2: Possibility of exercise or conversion</u>

3. Enterprises A, B and C own 40%, 30% and 30% respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Enterprise D. Enterprise A also owns call options that are exercisable at any time at the fair value of the underlying shares and if exercised would give it an additional 20% of the voting rights in Enterprise D and reduce Enterprise B and C's interests to 20% each. If the options are exercised, Enterprise A would have control over more than one half of the voting power. The existence of the potential voting rights, as well as the other factors described in SSAP 32 paragraph 14 and SSAP 10 paragraphs 3 and 4, are considered and it is determined that Enterprise A controls Enterprise D.

Example 3: Other rights that have the potential to increase an enterprise's voting power or reduce another enterprise's voting power

4. Enterprises A, B and C own 25%, 35% and 40% respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Enterprise D. Enterprises B and C also have share warrants that are exercisable at any time at a fixed price and provide potential voting rights. Enterprise A has a call option to purchase these share warrants at any time for a nominal amount, and, if the call option is exercised, would give Enterprise A the potential to increase its ownership interest, and thereby its voting rights, in Enterprise D to 51% (and dilute Enterprise B's interest to 23% and Enterprise C's interest to 26%).

5. Though the share warrants are not owned by Enterprise A, they are considered in the assessment, because they are presently exercisable by Enterprises B and C. Normally, if an action (e. g., purchase or exercise of another right) is required before an enterprise has ownership of a potential voting right, the potential voting right is not considered to be held by the enterprise. However, the share warrants are, in substance, held by Enterprise A, because the terms of the call option indicate that it is almost certain the option will be exercised. The combination of the call option and share warrants give Enterprise A the power to set the operating and financial policies of Enterprise D, because Enterprise A could currently exercise the option and share warrants. The other factors described in SSAP 32 paragraph 14 and SSAP 10 paragraphs 3 and 4 are also considered, and it is determined that Enterprise A, not Enterprises B or C, controls Enterprise D.

Example 4: Consider all facts and circumstances that affect potential voting rights, including the factors described in SSAP 32 paragraph 14 and SSAP 10 paragraphs 3 and 4

6. Enterprise A owns a 55% controlling ownership interest that also carries an equivalent percentage of voting rights in Enterprise B. Each of the other shareholders of Enterprise B holds less than 10% of the voting rights. Enterprise A writes a call option that is presently exercisable at a nominal strike price, and if exercised would reduce Enterprise A's ownership interest and voting rights to 48%. Enterprise A considers that it prima facie does not control Enterprise B, because the call option is currently exercisable. However, the existence of the potential voting rights, as well as the other factors described in SSAP 32 paragraph 14, are considered and it is determined that Enterprise A continues to control Enterprise B. In this circumstance, Enterprise A controls Enterprise B because another factor described in SSAP 32 paragraph 14, but not indicated in the example, affects the assessment.

Example 5: Management intention

7. Enterprises A, B and C each own 33% of the ordinary shares that carry voting rights at a general meeting of shareholders of Enterprise D. Enterprises A, B and C each have the right to appoint two directors on the board of Enterprise D. Enterprise A also owns call options that are exercisable at a fixed price at any time and if exercised would give it all the voting rights in Enterprise D. The management of Enterprise A does not intend to exercise the call options if Enterprises B and C do not vote in the same manner as Enterprise A. The existence of the potential voting rights, as well as the other factors described in SSAP 32 paragraph 14 and SSAP 10 paragraphs 3 and 4, are considered and it is determined that Enterprise A controls Enterprise D. The intention of Enterprise A's management does not influence the assessment.

<u>Example 6: Financial capability</u>

8. Enterprises A and B own 55% and 45% respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Enterprise C. Enterprise B also holds debt instruments that are convertible into ordinary shares of Enterprise C. The debt can be converted at a substantial price, in comparison to Enterprise B's net assets, at any time and if converted would require Enterprise B to borrow additional funds to make the payment. If converted, Enterprise B would receive 70% of the voting rights and Enterprise A's interest would reduce to 30%.

9. Though the debt instruments are convertible at a substantial price, the price is not so significant that the possibility of conversion is remote. The debt is presently convertible and the conversion feature gives Enterprise B the power to set the operating and financial policies of Enterprise C. The existence of the potential voting rights, as well as the other factors described in SSAP 32 paragraph 14, are considered and it is determined that Enterprise B, not Enterprise A, controls Enterprise C. The financial capability of Enterprise B to pay the conversion price does not influence the assessment.

APPENDIX B: ALLOCATION OF OWNERSHIP INTERESTS

The Interpretation requires the proportion allocated to the parent and minority interests in preparing consolidated financial statements, and the proportion allocated to an investor that accounts for its investment using the equity method to be determined based solely on present ownership interests. When an enterprise has, in substance, a present ownership interest, the Interpretation requires the proportion allocated to be determined taking into account the eventual exercise of potential voting rights and other derivatives that, in substance, presently give access to the economic benefits associated with an ownership interest.

<u>Example: Sale and a forward repurchase of ownership interests</u>

1. Enterprise A has a 75% ownership interest in a controlled enterprise, with Enterprise B having the remaining 25% ownership interest. Enterprise A sells 10% of its ownership interest at its fair value for $100 to Enterprise B and simultaneously enters into a forward agreement with Enterprise B to repurchase the 10% ownership interest at $115. Enterprise B receives a 7% p. a. return when the forward settles.

2. The sale and forward repurchase agreements are linked and the terms of the forward agreement are such that Enterprise A retains access to the economic benefits associated with the 10% ownership interest. Therefore, the proportions allocated to Enterprises A and B are 75% and 25% respectively when preparing the consolidated financial statements.

3. Instead of entering into a forward repurchase agreement, Enterprise A could have simultaneously written put options to and purchased call options from Enterprise B in relation to the 10% ownership interest, with the options having substantially the same fixed strike prices and exercisable at the same future date. In this circumstance, the proportions allocated to Enterprises A and B is still 75% and 25% respectively when preparing the consolidated financial statements.