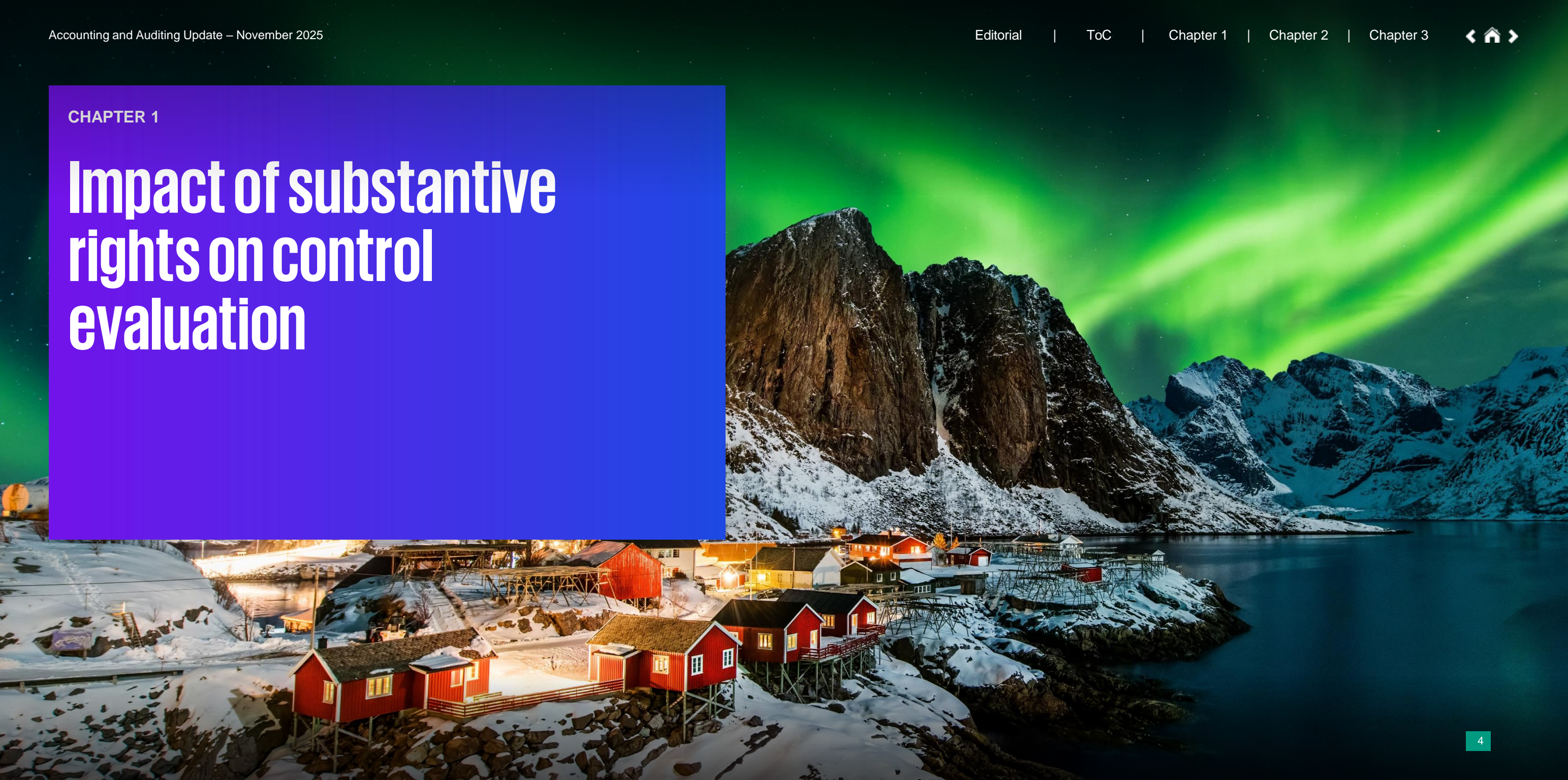


CHAPTER 1

Impact of substantive rights on control evaluation



Introduction

In today's complex corporate landscape, particularly in the context of business combination transactions, the assessment of control under Ind AS 110, *Consolidated Financial Statements*, serves as a cornerstone for determining whether an investor should consolidate an investee. Simply holding a majority stake does not automatically confer control; instead, Ind AS 110 requires a comprehensive assessment of the investor's rights and their practical ability to influence the key decisions of the investee's performance.

The standard defines control as the combination of three elements:

a) power over the investee,

- b) exposure or rights to variable returns from involvement with the investee, and
- c) the ability to use that power to affect those returns

To demonstrate power, the investor must hold rights that grant them the present ability to direct those activities which have a significant impact on the investee's returns – commonly referred as relevant activities. Furthermore, an investor may still have power even when other parties have rights that allow them to participate in directing relevant activities, such as having significant influence over the investee. Therefore, in evaluating whether an investor has power, Ind AS 110 requires the investor to evaluate both the nature of its own rights and those held by other parties.

Understanding the investor's rights over the investee's relevant activities

An investor can have power over an investee if they are able to direct the investee's relevant activities in the following circumstances:

- The investor holds the majority of the voting rights; or
- The investor holds less than a majority of the voting rights but:
 - Holds substantive potential voting rights;
 - Has rights arising from other contractual arrangements, including an agreement with other vote holders; and/or

- Holds voting rights that are sufficient to unilaterally direct the relevant activities of the investee - i.e. de facto power.

Given the importance of these rights, in this article, we will explore the concept of 'substantive potential voting rights'.

Substantive rights vs protective rights

As discussed in the preceding paragraphs, assessing control under Ind AS 110 requires a comprehensive evaluation of both the substantive rights held by the investor and those held by other parties.



Substantive rights commonly include voting rights and potential voting rights, such as call options over shares. For a right to be considered substantive, it must be exercisable at the time decisions about relevant activities are required, and the holder must have the practical ability to exercise those rights. Thus, determining whether rights are substantive requires careful judgement, considering all relevant facts and circumstances. Some of the key factors to consider in this assessment include:

- The existence of barriers that may prevent the holder from exercising the rights;
- The number of parties required to agree for the rights to become exercisable or operational;
- Whether the holder would benefit from exercising the rights, such as when the rights are ‘in the money’.

In addition to these factors, the analysis should also encompass the purpose and design of potential voting rights and any other involvement the investor has with the investee. This involves reviewing the terms, conditions, and underlying expectations or motives for the rights.

It is also equally important to distinguish protective rights - which relates to

fundamental changes in the investee’s activities or are rights that apply only in exceptional circumstances. Rights associated with the following matters are generally considered protective, as they relate to significant changes in the entity:

- amendments to the entity's constitution;
- the liquidation of the entity or commencement of bankruptcy proceedings;
- share issues or repurchases; or
- the sale of a significant portion of the entity's operating assets.

Such rights do not confer power or prevent other parties from having power and control over the investee.

Having clarified the distinction between substantive and protective rights, it is now important to understand how potential voting rights fit into this framework.

Evaluating potential voting rights

Potential voting rights - such as call options over shares - are frequently encountered in practice and, depending on the specific circumstances, may be considered substantive. These rights can provide an investor with unilateral decision-making

authority, for example - a call option that becomes exercisable in the event of a deadlock. Although the exercise of such an option is contingent on a specific event, this contingency does not limit the power associated with the option; this is because the contingency relates to decision making and the call option is exercisable when it is actually needed. Therefore, a holistic evaluation is necessary, taking into account all relevant factors, including the purpose and design of the arrangement.

Building on this holistic approach, it is essential to note that a change in the market conditions alone will not typically cause potential voting rights to become substantive. Instead, the assessment must consider a combination of factors, and in certain cases, changes in market dynamics together with other circumstances may trigger a reassessment of control. Moreover, evaluating whether potential voting rights are ‘in the money’ or ‘out of the money’ can be complex. This is because - while a right may appear ‘out of the money’ based on current market price, but existence of a control premium may mean that, from a controlling-interest perspective, the rights are actually ‘at or in the money’.

Therefore, a comprehensive assessment that considers barriers to exercise, timing of decision-making, and the overall design and purpose of the arrangement is essential to determine if such rights are truly substantive. Regulatory bodies also emphasise this principle.

The European Securities and Markets Authority (ESMA) publishes enforcement decisions to guide market participants on the accounting treatments that comply with the International Financial Reporting Standards (IFRS). Ind AS 110 is closely aligned with the principles of equivalent IFRS. The following case study, drawn from ESMA’s enforcement decisions, provides a practical illustration of how substantive rights are evaluated in a control assessment under IFRS10/Ind AS 110.

Case study

In June 2021, Company A (investor), a retail entity, acquired a 44 per cent interest in Company B (investee). This share purchase agreement included both - a put option for the founders of the investee and a call option for the investor. These options granted the founders the right to sell their shares under certain conditions and the investor the right to purchase the founders' shares at any time. However, the terms of the put and call options were not identical:

a) Founders' put option:

- Exercisable if the founders remain employed at the investee for at least two years (or no bad leaver¹ event occurs within three years)
- The exercise price was Euro X per share. The total consideration—calculated as Euro X per share multiplied by the number of founders' shares - would be settled using the investor's shares at a predetermined conversion price.

- If a 'bad leaver' event was to occur within three years and the founders had previously exercised their put option, the founders would be required to refund the entire amount received, retaining only Euro 2 per share.

b) Investor's call option:

- The investor could purchase the founders' shares at any time within three years.
- The call price is Euro X per share, unless a leaver or bad leaver event occurred within two or three years, respectively, or within 15 days after the three-year period. In such cases, the price would reduce to Euro 2 per share.
- Payment terms: Euro X per share would be settled in the investor's shares at a predetermined price, while Euro 2 per share would be paid in cash.

Subsequently, in November 2022, the investor purchased the remaining 56 per cent stake in the investee. This transaction was accounted for as a step acquisition in accordance with

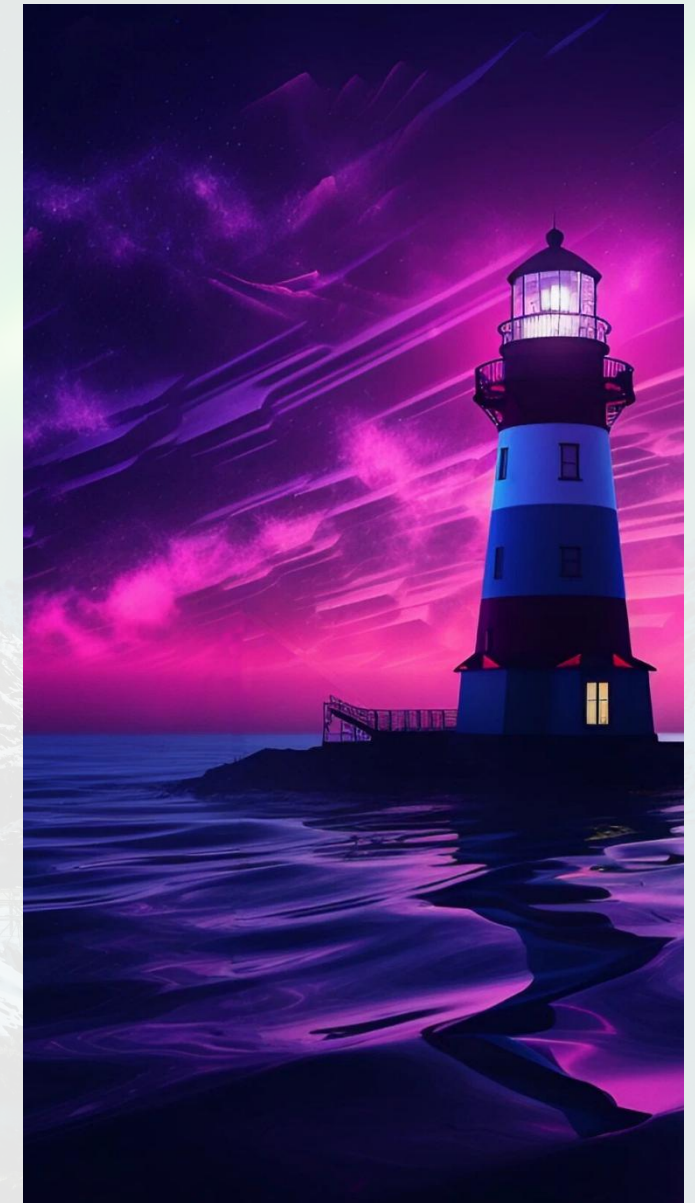
IFRS 3, *Business Combination*² requiring purchase price allocation and recognition of the subsequent acquisition as a business combination.

ESMA's view on control assessment

ESMA disagreed with the accounting treatment applied by the investor. According to ESMA, the investor should have considered substantive rights when assessing control under IFRS 10, *Consolidated Financial Statements*³. ESMA's decision considered the following factors:

- After the initial investment in 2021, the investor held 44 per cent ownership in the associate i.e. the investee and a call option for acquisition of the remaining 56 per cent.
- Assessing whether potential voting rights are substantive requires a holistic evaluation that goes beyond simply comparing exercise prices; it involves assessing the underlying purpose and design of the call instrument as well.

1. For example, fraud
 2. Ind AS equivalent - Ind AS 103, *Business Combination*
 3. Ind AS equivalent – Ind AS 110



- As per IFRS 10/Ind AS 110, the call options were substantive rights because:
 - They could be exercised at any time within the three years for either Euro X or Euro 2 per share, depending on the timing of the exercise
 - No economic, legal, or contractual barriers existed that would prevent the investor from exercising the call options. No party could have prevented the investor from controlling the investee.
 - It was observed that the exercise price of the call option, Euro X per share, exceeded the amount the investor had paid per share for the acquisition of the initial 44 per cent interest in the investee, by approximately 9 per cent. However, ESMA noted that a 9 per cent premium for the controlling interest in the investee did not necessarily imply that the call options were 'out of- the-money' as in the issuer's jurisdiction, average control premiums approximate 20 per cent.
 - With regards to the purpose and design of the call option, it was noted that the investor was the only customer of the

investee and the investee's operations and products were important to the investor's activities.

- Reduction of call price to Euro 2 per share after three years or upon founders' termination indicated a high likelihood of full acquisition from the start.
- The investor's 2022 annual report indicated that the acquisition of the 56 per cent share in the investee had been completed a year earlier than originally expected

Based on the above factors, ESMA determined that the call options, combined with the 44 per cent stake, gave the investor the ability to direct relevant activities from 2021. As a result, the investor should have consolidated the investee in 2021 itself.

[Source: Adapted decision ref EECS/0126-08 with modifications from ESMA, 30th Extract from the EECS's Database of Enforcement, Reference No. ESMA32-193237008-9182, dated 27 June 2025]

Bottom line

The assessment of control under Ind AS 110 requires a rigorous, principle-based approach that goes beyond the simple ownership percentages. Substantive rights - especially potential voting rights like call options - can be pivotal in determining whether an investor truly controls an investee. As highlighted in ESMA's case study, control may exist even without majority stake, if the investor holds rights that are substantive, exercisable, and free from significant barriers.

Therefore, decisions regarding the consolidation of an investee should be based on a comprehensive evaluation of all relevant facts, including the design and purpose of contractual arrangements and the strategic relationship between the investor and investee. In this regard, entities should

consider the following points while assessing control over an investee:

- Closely monitor relevant events and assess the specific facts and circumstances for each investee that may be impacted.
- Consider whether there is a need to reassess the accounting for investees, especially in light of changes in business arrangements or market conditions.
- Evaluate whether there has been a change in any of the three key elements of control - power, variability, and linkage.

In summary, entities should ensure their control evaluations are robust, transparent, and aligned with both the letter and spirit of Ind AS 110. This will not only support accurate financial reporting but also enhance stakeholders' confidence.