

Explaining Power Over the Investee - the Rights that Give the Possibility to Directs the Investee`s Relevant Activities

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Abstract: - The links created on all levels between the parent company and its subsidiaries have generated along time debates regarding the regulations applicable in the audit activity in order to protect the above mentioned entities. Throughout this paper we will progressively describe the pylons that represent the foundation of the regulations subject to the audit activity in this organizational environment.

Key-Words: - financial statements, subsidiaries, audit activity, regulations, interests

1 Introduction

Power arises from rights. Sometimes assessing power is straightforward, such as when power over an investee is obtained directly and solely from the voting rights granted by equity instruments such as shares, and can be assessed by considering the voting rights from those shareholdings. In other cases, the assessment will be more complex and require more than one factor to be considered, for example when power results from one or more contractual arrangements

In the consolidation process, one of the most significant steps is the determination of the power the investor has over the investee.

A thorough analysis must be performed on all aspects of the control and whether the investor has or doesn't the power to direct the investee's relevant activities. An investor with the current ability to direct the relevant activities has power even if its rights to direct have yet to be exercised.

Evidence that the investor has been directing relevant activities can help determine whether the investor has power, but such evidence is not, in itself, conclusive in determining whether the investor has power over an investee.

2 Attention over „the possibility to direct” and not to effectively apply the power

The power resides in rights. To have power over the investee, an investor needs, to have rights that provide the possibility to direct the relevant activities of the investee.

Therefore, establishment of the power is made on the investor's possibility to direct the relevant activities of the investee. The International Financial Standard Consolidated Financial Statements - IFRS 10 does not require the investor to use its power. An investor that has the possibility to direct the relevant activities of another company has power over it even though this power is not exercised.

Moreover, the evidence that states an investor has directed the relevant of an investee can aid in determining the investor has or hasn't power, but this proof alone is not the determining factor in assessing that the investor has the power.

An investor can have the power over an investee even if other entities have rights that provide them the ability to direct the relevant activities (e.g. another entity has a significant influence).

3 Rights that give an investor power over an investee

The rights that can give an investor power can differ between investees¹. Different types of rights that, either individually or in combination, can give an investor power over an investee include, but are not limited to:

- Rights in the form of voting rights (or potential voting rights);
- Right to appoint, reappoint or remove key members of the investee's management personnel who have the rights to direct the relevant activities;
- Right to appoint, reappoint or remove another entity that directs the relevant activities;
- Rights to constrain the investee to intro or veto in matters that can benefit the investor;
- Other rights (such as rights written in management agreements) that gives the owner the possibility to direct relevant activities.

4 Evidence to be taken into consideration when the assessing is difficult in matters of determine whether the rights of an investor are enough or not in order to provide power

When there is difficult to assess whether an investor's rights are sufficient to provide power, the investor should consider evidence regarding whether it has the practical ability to unilaterally direct the relevant activities. Also, considerations must be given to whether:

- The investor can, without having the contractual right to do so, appoint or approve the investee's key management personnel who have the ability to direct the relevant activities;
- The investor can, without having the contractual right to do so, direct the investee to enter into, or can veto any changes to, significant transactions for the benefit of the investor;
- The investee's key management personnel are related parties of the investor (e.g. the chief executive officer of the investee and the chief executive officer of the investor are the same person); and/or
- The majority of the members of the investee's governing body are related parties of the investor.

In some cases there can be indications that the investor has a special relationship with the investee, suggesting that the investor has more than a passive interest in the investee.

The existence of any individual indicator or a particular combination of indicators does not necessarily mean that the power criteria are met. However, having more than a passive interest in the investee indicates that the investor has other related rights enough to give it power or provide evidence of existing power over the investee. In combinations with other rights, the following may indicate that the investor has power over the investee²:

- The investee's key management personnel who have the ability to direct the relevant activities are current or previous employees of the investor;
- The investee's operations are dependent on the investor, such as in the following situations:
 - other investee depends on the investor to fund a significant portion of its operations;
 - other investor guarantees a significant portion of the investee's obligations;
 - other investee depends on the investor for critical services, technology, supplies or raw materials;
 - other investor controls assets such as licenses or trademarks that are critical to the investee's operations; and/or other investee depends on the investor for key management personnel, such as when the investor's personnel have specialized knowledge of the investee's operations;
- A significant portion of the investee's activities either involve or are conducted on behalf of the investor; and/or;
- The investor's exposure or rights in terms of returns from its involvement with the investee is disproportionately greater than its voting or other similar rights. For example, there may be a situation in which an investor is entitled or exposed to more than half of the returns of the investee but holds less than half of the voting rights of the investee.

¹ The International Financial Standard Consolidated Financial Statements - IFRS 10:B14.

² The International Financial Standard Consolidated Financial Statements - IFRS 10:B19

The higher the exposure, or right, to the variation of profits by involving within an investee, the higher the stimulant for the investor in obtaining enough rights that provide power. Therefore, having a high exposure to profits uncertainty represents an indicator of power for the investor.

However, taking into consideration the investor's exposure is not enough for assessing whether the investor has or doesn't have power over the investee.

5 Substantive rights

In assessing whether an investor has it has the power or not, an investor is taking into consideration only the substantive rights in relationship with the investee. Substantive rights that are to be taken into consideration are the one held by the investor and other third parties. For a right to be substantive, its owner must have the practical ability to use that right.

Determining whether the rights are substantive or not, judgment must be applied by taking into account all factors and circumstances. The international standard IFRS 10 states a non-exhaustive list of factors to be taken in consideration:

- Whether there are barriers (economical or other) or not that can prevent the owner/owners or not in using their rights.

- When the use of rights implies an agreement between more individuals or when the rights are owned by more than one individual, whether there is or not a mechanism that supplies for the parties the practical possibility to collectively use the rights if they choose to;

- Whether one or more parties that owns rights would benefit or not from using the rights.

Moreover, for the rights to be substantive it must be used in the moment in which the decisions regarding the relevant activities must be taken.

Examples for the identification of substantive rights:

1. The investee holds the annual shareholders meeting in order to take decisions that will direct the relevant activities of the company. The next shareholders meeting will be in 8 months from now.

However, the shareholders that individually or collectively hold at least 5% of the voting rights can request an extraordinary meeting that can modify the actual policies regarding the relevant activities, but also have the obligation to inform the rest of the shareholders with the extraordinary meeting with at least 30 days in advance. The policies that alter the relevant activities can be modified only within an extraordinary or normal shareholders meeting. Those policies may include the approval for the sale of the company's significant assets and also purchase or disposal of significant investments.

2. An investor holds the majority of the voting rights over an investee. The investor's rights are substantive due to the fact that the investor can take decision that can direct the relevant activities of the company at the time it is needed. The fact that these actions must be announced within 30 days ahead does not prevent the investor in using the voting rights that he holds in order to direct the relevant activities from the moment he obtained the shares.

3. An investor that holds an option for purchasing the majority of shares from an investee due in 25 days. This option grants the investor substantive rights and the possibility to direct the relevant activities of the company even though he hasn't used its option.

4. An investor holds a forward contract for the purchase of majority of investees' shares with no other rights. The maturity term of the option is 6 months. Opposing to other examples presented above, the investor does not hold the possibility to direct the investee's relevant activities. Present owners have the possibility to direct the relevant activities due to the fact that they can alter the policies regarding the relevant activities before the forward agreement reaches maturity.

Substantive rights that can be used by other parties can prevent an investor to control the investee. These rights do not require that the owner has the possibility to take decisions. As long as the rights are not protective, substantive rights held by a third party can prevent an investor to control the investee even though the rights provide to their owner only the possibility to approve or deny decisions in relationship with the relevant activities.

6 Protective rights

In determining whether certain rights provide the investor with power over the investee or not, an investor must determine if its rights or the rights of other are protective or not.

Protective rights are determined as rights designed to protect the interests of a party which owns these rights without giving the respective party power over the investee.

Taking into consideration the nature of the protective rights, an investor that only holds protective rights cannot own the power and cannot prevent another party to hold the power over an investee.

Examples of protective rights include:

- The right of a party that has granted a loan to prevent the loaned parties to run certain actions that can significantly alter the credit risk from the loaned to the lender.

- The right of a party that holds non-controlling interests over an investee to approve significant capital expenditures than normally needed or to approve the investee to issue capital or expenditure instruments and

- The right of a party that has granted a loan to execute the asset of the loaned entity in the situation in which the loaned party does not fulfill its contractual provisions in respect of reimbursing the loan.

In certain situations, structured entities are incorporated for holding one asset. The procurement of this asset is financed through a loan for which the assets represent also the role of collateral guarantee. In the situation of non-compliance with the contractual provisions, the lender holds the right to own the asset but does not own the recourse right over other assets the loaned structured entity or over another's entity assets. At the moment the entity is incorporated, it shall own only the above mentioned assets and the loan used for procurement.

The fact that a structured entity holds only one asset does not modify the evaluation that the entity that has granted the loan holds or doesn't the protective rights to seize the asset. If the rights are protective by nature, it should be treated as such no matter if these rights refer to one or more assets held by the entity or if it refers to only one asset. The purpose of the rights needs to be settled for the party that has benefited from the loan if it is intended to provide the lender the power over the loaned party or only protection of the interests' for the lender by the loan agreement.

Example: Potential rights that prevent the shareholders of the majority of voting rights to have control:

Entities A, B, and C hold 60%, 20% and respectively 20% of shares in Entity D. There is an exception at the time the potential rights are used for decisions made over the relevant activities of Entity D that are being made only by the majority of votes at the general shareholders assembly.

Despite the fact that shareholders of Entity D have signed an agreement in which Entities B and C have potential rights at the shareholders assemblies regarding the acceptance or decline of actions taken by Entity A regarding the relevant activities. If Entities B and C use their potential rights, the proposed actions will be approved only of the shareholders on minimum 75% of voting rights agree.

In the above described circumstances, the rights owned by Entities B and C are not only protective rights. Potential rights do not only protect the interests of Entities B and C but also provide the possibility to prevent another party (Entity A) from taking unilateral decisions regarding the relevant activities of Entity D. Taking into consideration potential rights held by Entities B and C, Entity A does not hold control of Entity D.

7 Relevant activities are directed by voting rights

Frequently, voting or other similar rights provide power for the investor, individually or in combination with other agreements. For example, the general case in which an investee has a pallet of financing and operational activities that significantly affects its profits that require significant decisions to be taken constantly.

I. Power by a majority of voting rights

An investor that holds the majority of voting rights within an investee holds the power in the following situations (except the above mentioned ones):

- Relevant activities of the investee are directed by a single vote of the majority voting holder or

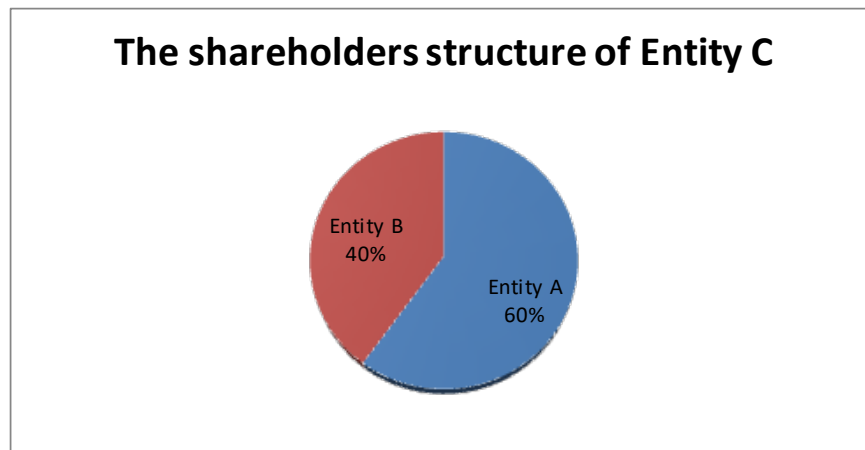
- A majority of members from the governance body that directs the relevant activities of the investee is named by a vote of the majority voting rights owner.

Example: Relevant activities of an investee are directed by a shareholder with a majority of voting rights within the investee:

Entities A and B hold 60 % and respectively 40% of the ordinary shares of Entity C. Relevant activities of Entity C are directed by the majority of voting rights within the shareholders assemblies. Each ordinary share carries by itself a vote in the shareholders assembly. If no other factors are taken into consideration (eg. Agreements between the shareholders of Entities A and B that have other provisions) the relevant activities of Entity C are directed by the entity that holds the majority of votes.

As a result, in absence of other significant factors, Entity A holds the power over Entity C due to the fact that it holds the majority of votes within Entity C.

Fig. 1 The shareholders structure of Entity C

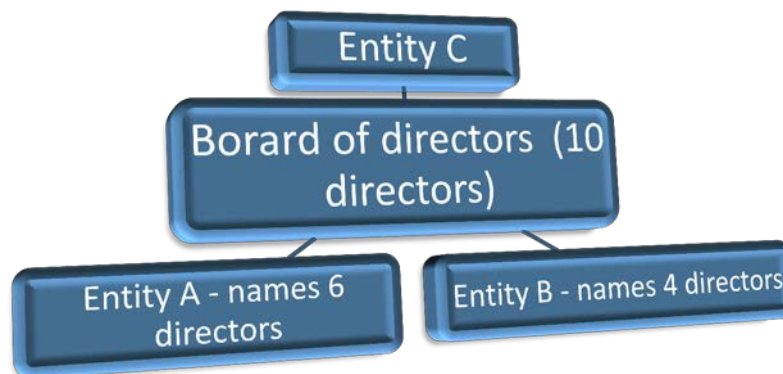


Source: issued by the authors

Example: Relevant activities of an investee are directed by a governing body and the majority of the members are named by the shareholder that holds the majority of the voting rights in the investee

Entities A and Entity B hold 60%, respectively 40% of the Entity C ordinary shares'. The investee is governed by the Board of directors. Entities A and B are entitled to name 6, respectively 4 directors, proportionally with the shares they own. As a result, in the absence of other relevant factors, Entity A holds the power over Entity C due to the fact that it has the right to name the majority of directors in the Board, therefore to direct the relevant activities of Entity C.

Fig. 2 Components of Entity C



Source: issued by the authors

II. Majority of voting rights but no power

An investor that holds more than half of the voting rights of an investee will have power over the investee through these rights only if the rights are significant and provide the investor the ability to direct the relevant activities, ability that is mainly made by determining the operational and financing policies.

Sometimes even though the investor holds the majority of voting rights of an investee, it doesn't necessarily hold the power. This situation is found at the time the investor holds the majority of voting right, but these votes are not substantive. Accordingly to IFRS 10, there are two situations:

- The situation in which another entity holds rights that provide the possibility to direct the relevant activities of an investee and that entity does not represent an agent of the investor, the investor does not possess the control over the investee.

- The situation in which the relevant activities of the investee are directed by a Government, Court House, Administrator or another regulatory factor. In these circumstances, the owner of the majority of voting rights cannot have the power.

It is not to be assumed that naming and administrator or liquidator will prevent the entity that holds the majority of voting rights will have the power. Rather than otherwise, it is necessary to be taken into consideration if the power held by the administrator or liquidator is enough to prevent the investor in directing the relevant activities of the investee. Although most often is the case of liquidation, these situations do not lead to the loss of control held by the entity that holds the majority of voting rights.

III. Power obtained with less than the majority of voting rights

The international standard IFRS 10 provides the information that an investor that holds less than the majority of voting rights of an investee can have the power over the investee. An investor can have the power in the following circumstances by:

- An agreement between the investor and the other parties that hold voting rights;
- Rights that are provided by certain contractual provisions;
- Voting right of the investor, if there are sufficient to provide the practical ability to direct the relevant activity;
- Potential voting rights;
- A combination of the above mentioned.

8 Power in the situation in which voting rights have no significant influence over the profit of the investee

In contradiction with the above mentioned situations, in certain circumstances voting rights can have no impact on the investee's profits (ex. The situation in which a contractual agreement determines the direction of the relevant activities and the voting rights has impact only in the administrative responsibilities).

In the situation the investee is structured in such a manner that voting rights do not represent a dominant factor in determining the controlling part, an investor must, also, give increase attention for these aspects when it takes into consideration the purpose and the structure of the investment:

- Risks at which the investee has been incorporated to be exposed;
- Risks at which the investee's has been incorporated to transfer towards involved parties and
- If the investor is exposed at any of the mentioned risks.

In such circumstances, considerations regarding the risks include not adverse risks but also the favourable risks.

"Information economy involves sophisticated maximizing behaviours that lead to the signing of complex contracts."³ All the risks attributable to an investee do not necessarily associate with the relevant activities. Even though a certain risk can be present and affect the involved parties, the entity does or doesn't have in its structure means to diminish the risk. As a result, a relevant activity may not be found in relationship with that risk (for example the documents of financing the entity may include activities to diminish the exposure risk).

In the situation in which a risk is associated to a relevant activity, an investor won't be able to influence the variability of returns that can occur from that risk. As a result, the estimation of the first and third element of

³ Grigore, M. Z. (2009). Information economics, instrument of analysis in new microeconomics. *Lex ET Scientia International Journal (LESIJ)*, 16(2), 362.

control (the power of an investor over and investee and the ability to use its power to influence the amount of profit of an investee) would be concentrated on other present risks to which the relevant activities are associated.

Nevertheless, if a relevant activity cannot be associated to any risks, the variability that emerges from that risk must be analysed from the point of view of the decisional factor that can be the principal or the agent.

Example: Risks that is not associated to any relevant activities

An entity is incorporated for the procurements from a financial institution mortgages over some residential investments with a value of 100 Million UM at a fixed rate on 30 years. The entity is financed by 100 Million UM on a period of 3 years and guaranteed with subordinated debt titles.

Every month, the owner of the subordinated debt titles receives interest payments along with the interest reimbursement from the mortgages and any encashment of principal is used to cover the instalment subordinated to the loan. The documentation regarding the incorporation of the entity forbids it to cease its mortgages, procurement of investment are hiring derivative transactions.

Therefore, the entity exposes its investors to the following risks:

- Credit risk – the risk that mortgages will not be paid;
- Prepayments risk – the risk that the mortgages will be reimbursed in advance and the amount of interest will be reduces;
- Interest risk – the risk that the net book value of fixed instalments of mortgages will fluctuate along with the modification of the interest rated on the market.

Due to restrictions in place, the possible actions to be taken in order to manage the prepayments risk or the interest risk do not exist, therefore no relevant activity can be associated to these risks.

Analysing the fact that an investor has or not the power over an investee in influencing the amounts of profits will, in this case scenario, focus on the credit risk. In this respect, the investor must identify the activities associated to the credit risk and who holds the ability of taking decisions in this matter.

“In current activity, banks facing with a large range of risks related to credit operations and commercial activity, which may generate profit mitigation or even losses. One of these risks is the operational risk, which are a major source of financial loss in the banking sector and which importance grows up in the same time with financial globalization and banking activity diversification”⁴, fact that influence at a high level all the decisions that an investor has to make, as a result of taking into consideration all the inherent risks.

4 Conclusions

In applying the consolidation standard’s provision a thorough analysis must be performed due to the fact that there are lots of aspects to be taken into consideration. As we presented in the above analysis, there are several steps and details to be taken into consideration in order to properly asses whether an investor has the relevant rights that provide control over the relevant activities of the investee.

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⁴ Sudacevschi, M. (2013). Operational Risk Management in Banking Industry, *Ovidius University Annals, Economic Sciences Series*, 13(2), pg. 514

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