SIGNIFICANCE OF CONTROL IN THE PREPARATION OF FINANCIAL REPORT

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Abstract - Control, which underlies recognition of assets, identification of consolidation of enterprises, preparation of the consolidated financial report etc. is an important factor in the preparation of the financial report. Realizing the aforesaid, the IFRS Board developed the uniform concept of control targeted at improved preparation and submission of the financial report. The ultimate goal of the concept is evaluation and detection of control. IFRS defines the concept of control, the criteria of its recognition and its main characteristics, such as the relevant activity, authority with regard to the enterprise into which an investment was made, the inconsistent income risks and influence on income by the exercise of power. Detailed assessment of control over the enterprise into which an investment was made is especially important in case of unclear authority.

Index Terms - Control, relevant activity, management authority, inconsistent incomes.

I. ECONOMIC BENEFIT AND POTENTIAL OF ASSETS

According to the conceptual framework of the financial reporting, control is the expected potential of an asset to generate the economic benefit and restrict it for the others. In this regard, the concept of control has to do with two features of assets: the economic benefit and the potential to generate it. Therefore, it is important to understand the essence of the economic benefit. In line with the conceptual framework of the financial reporting, the economic benefit materialized in the assets is their potential to support the direct or indirect influx of cash means and their equivalents into an enterprise. There are several ways in which the prospected economic benefit materialized in the assets may be obtained by an entity. An asset may be used separately or jointly with the other ones, in the production of goods and rendering services, exchanged for another asset, used to meet a liability or distributed among the entity owners [1].

In my view, connection between the economic benefit and control set out in the Frameworks may be restated in simpler terms: the assets are capable of attracting cash means, which is called the economic benefit, while the use of this potential means control.
The concept of the economic benefit underlies recognition of assets and therefore it should be determined whether an asset has the potential to generate the economic benefit. An asset's potential to bring the economic benefit is assessed by the "substance over form" principle, i.e. its content and the actual situation as against the legal form. Relying on the principle, not the property right but control is a criterion of asset recognition, which defined the way in which a leased asset is to be recognized: an asset is registered with the lessee, who gets the economic benefit generated from its use [2]. IFRS 16: "Leases" describes characteristics of control over a leased asset one of which is the right to get the economic benefit. However, it's not only the lessee but the lessor who gets the economic benefit from the leased asset by way of lease payments. I suppose that the new regulation for lease accounting has more to do with transparency of liabilities rather than control. At the same time, the potential to control the expected economic benefit from intangible assets is generally subject to the legal rights.

II. CONCEPT OF CONTROL

The concept of control is explained in detail in IFRS 3: "Business Combinations" [3]. according to which control means the right to direct the financial and economic policy of an entity for the purpose of economic benefit. The explication makes it evident that the right to direct is essential to control.
The International Accounting Standards Board (IASB) points out that the concept of control is focused on collaboration of two entities. Namely, whether one has the right to direct the financial and operational policy of the other for the purpose of benefit. Therefore, regardless of the combination, in order to identify the buyer enterprise, it is important to determine which of the two combined entities has the right to direct the financial and operational policy of the other for the purpose of benefit.
The concept of control is especially important in the preparation of the consolidated financial statement. According to IFRS 10 - "The Consolidated Financial Statement", control is the only ground for an entity to be reflected in the consolidated financial statement. The standard introduced the uniform model of control for all the companies and defined the principles of recognition of the control, namely how those should be applied in order to determine control over the investee and the necessity of its involvement in the consolidated financial statement.
The IFRS 10 guidelines are to be applied in order to identify the entity that gains control over an acquired

one. The standard states that the investor controls the investee only if it takes on the risks associated with the variable returns from its participation or has the right to them and, also, can influence the income through its power over the investee [4].

Thus, only if the factors below are true for the investor will it control the investee:

a) The right to direct the relevant activities of the investee;
b) Exposure to the risks associated with the variable returns from its participation or the right to them, and
c) The potential to wield the power regarding the investee in order to influence its own incomes.

I suppose that the factors above, i.e. when the investor has the right to control should be considered the criteria of control recognition. It will make the concept clearer.

Under IFRS 10, the power is the valid rights to direct the relevant activities at the moment. The relevant (material) activities are the ones of the investee, which make significant impact on its incomes. Instances of the material activities are determination the operational policy, adoption of the resolution on investment, appointment of the Top Management and management of the material investments.

The right to manage (direct) includes the voting or contractual rights, the potential voting rights, the right to appoint the Top Management, that of adoption of a resolution under the management contract and the right of dismissal.

In certain circumstances, it may be difficult to determine whether an investor has sufficient rights to grant it power regarding the investee. In such cases, in order to assess its power, the investor has to consider evidence of its authority to unilaterally and practically manage the relevant activity. Determination whether those are actual rights, calls for consideration and decision-making, with all the facts and circumstances taken into account. Inter alia, the factors to be considered are as follows [5]:

- Detection of the hindrances (economic etc.) that impede the owner from exercising the rights above (e.g. penalties and incentives, operational barriers, the constituent, legal and regulatory documentation of the investee);
- The necessity of approval of the said rights by several parties or when the same rights are granted to several parties and availability of the way for them to actually exercise the rights and act jointly to this end;
- Use of the right by the relevant party;
- The acts relevant to the resolutions regarding change of activities.

The other criterion of availability of the control is the right to get variable returns from participation in the invested companies. The fact is that the actually obtained economic benefit does not always correspond to the expected one and thus, it is exposed to a risk. The risk is probable reduction of the expected incomes or the probability of contingency costs. The reasons behind the risks are inability to forecast the economic developments, which may have an adverse affect on the incomes and loss of property and cash means. The risk factors, such as a bank interest rate, market demand, fluctuating prices and exchange rate, competitive environment, economic stability etc. are beyond the control of the entity.

Variability of the incomes is to be agreed regardless of their legal form. Under IFRS 10, the returns variable in terms of content, are those the amount of which depends on the profitability of the investee [6]. For instance, IFRS 10 states that the variable returns are dividends, royalties, fixed interest bonds, commission for management of assets of the investee etc.

The interest charged to the fixed interest bond is regarded the variable returns since it is exposed to the default payment risk, while the investor will depend on the bond issuer's credit risk. Thus, degree of variability depends on the bond's credit risk. Similarly, the fixed fee, which the investor is paid for due management of assets of the investee is the variable returns since it subjects the investor to the investee's default obligation risk. The degree of variability depends on the investee's potential to get the income sufficient for the payment of the aforementioned fee. Thus, the variable returns is broadly interpreted and surpasses the advantages relevant to the rights granted by held shares [7].

However, the right to the relevant activity granted by participation in the investees and the variable return risk are insufficient for control over them. Apart from those, the investor is to prove that it can influence the income by exercising its power over the investee, which some times is referred to as "association with". The association is down to the investor's authority to carry out (adopt a resolution) the relevant activity on its own (as the principal) or the other investors' behalf who delegated their rights to it (the agent) [8], [9].

In order to determine whether it is the agent, the decision-maker is to analyze all the factors below: limits of its tight to the resolution regarding the investee, the other parties' rights, the remuneration it is entitled to under the agreement(s), the decision-maker's risks regarding the variable returns from the investee arising due to its participation in a different way.

For the investor to confirm its control especially in case of complex agreements, it should regularly apply evaluative reasoning and consider multiple factors. Evaluative reasoning is especially important for assessment of the real power in the cases, such as availability of the majority stock and the informal factors, the other parties' rights, the potential rights,

analysis of the structured entities, identification of the de facto agent and principal etc. [10].

The investor is obliged to regularly revise and if, required, reassess the investee's status. Namely, if even a single element of control is affected by change of facts or events, control over the investee should be reconsidered and reassessed. For instance, reassessment is required when as a result of material changes to the investment management or structure and, also, certain events the investor loses its power, the right to the variable returns or the one to influence them.

IFRS 10 recommends that in order to assess its control over the investee and determine its relevant activities, the way the resolutions regarding them are adopted, who is currently vested with the managerial powers and gets the income from them, the investor should consider and analyze the investee's objective and structure.

The analysis of the investee's objective and structure may make it evident that control over the investee is exercised by means of the equity instruments, such as the ordinary shares granting the investor the pro rata voting right. In this case, it should be determined whether there are some additional agreements, which make it possible to change the way resolutions are adopted. Assessment of control should focus on identification of a party (if any), which may exercise the voting right sufficient for determining the operational and financial policy of the invetsee.

The voting rights in the investee may not be the crucial to determining who controls it. For instance, when the voting rights are associated only with administration and the relevant activities are managed according to the contractual arrangements. In such cases, IFRS recommends that in analyzing the objective and structure of the investee, the investor should also consider the risks envisaged by the investee in organizing its own structure, also the ones, which were to be transferred to the other parties involved in the investee and determine whether the investor is exposed to all or just some of them. The risk assessment should include not only the fall but the rise of stocks.

In the assessment of control, along with the objective and structure of the investee, the investor should analyze the other factors described in IFRS 10, namely:

- The objective and structure of the investee;
- The relevant activities and the way the decisions on them are taken;
- Do the powers the investor has at the moment allow him to manage them?
- Is the investor exposed to the risks associated with the variable returns derived from its participation in the investee or has he the right to get them? And
- Can the investor wield the granted powers in the way to affect the volume of its incomes?

COMBINATION AND CONTROL OF ENTITIES

In the combination of entities, the buyer entity gains control over the acquired one. Generally, the economic entity, which gives money, its equivalents etc. assets or assumes an obligation for the purpose of gaining control, is deemed the buyer. When in the combination, it is unclear which of the combined entities the buyer is, the control may be determined by the other identification factors of the buyer entity indirectly specified in IFRS 3. Namely, among other factors to be taken into account in the identification of the buyer, the ones below should be considered:

- Generally, the buyer is one of the combined entities, (whose size represented in, let's say, assets, returns or profit) is significantly larger than that of the other ones;
- In the determination of the buyer in the combination of more than two economic entities, the initiator of the combination should be taken into account;
- In the combination of entities formed mainly via the exchange of stocks, the buyer is generally the one, which will issue its own stocks;
- The dominant entity in terms of management – one of the combined entities has the privilege of selection of the managerial staff.

In the identification of the buyer in the combination of entities formed by exchange of stocks, we should also consider the factors and circumstances below:

- Proportion of the voting rights in he combined economic entity. Generally, after combination of entities, the buyer is the one whose owners as a group retain or get most of the voting rights in the combined entity. In order to determine which group of owners retains or gets most of the voting rights, the entity should consider any or special agreements on the voting right and, also, the availability of options, warrants or convertible securities;
- Availability of the dominant minority voting right in the combined economic entity, if none of the other owners or a group thereof have the majority vote, generally the buyer will be the entity in the combination whose owner or a group thereof have the dominant minority voting right in the combined economic entity;
- Composition of the management body of the combined entity – generally, the buyer will be one of the combined entities, whose owners are entitled to selection, appointment or dismissal of members of the group's management body;
- Composition of the Top Management of the combined entity - generally, the buyer will be the entity, whose Management is dominant in the management of the group.

Conditions of exchange of stocks - generally, the buyer will be the entity of the combination, who pays the premium (additional) sum larger than the actual, pre-combination value of the other combined entity(ies) stocks.

JOINT, ASSOCIATED ENTITIES AND CONTROL

The concept of control is important not only for the recognition of assets, combination of entities and consolidation of the financial statement but also, identification of a joint activity, the joint and associated entities. Namely, the characteristics of control, such as the relevant activity and power underlie the identification of the joint activity (IFRS 11 "Joint Activity"), the joint and associated entities (IAS 28 – Joint and Associated Entities). The standards define the joint control and significant influence. The former is the contractual right to the joint control over an activity, which exists when unanimous consent of the controlling parties is required for the decision-making about the relevant activities [11]. In order to determine the joint control, an entity should apply the concept of control as defined in IFRS 10 in order to determine whether all the parties or a certain group thereof are exposed to the risks of variable returns or whether they are entitled to get the returns and able to influence the returns within their scope. The significant influence means the investor's right to participation in the decision-making on the investee's financial and operational policies, which however, does not imply the investor's right to control (individually or jointly) the policies [12].

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