

# MOVEMENT OF FINANCIAL RESOURCES IN AFFILIATED SMES

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## ABSTRACT

The object of the study is represented by non-public companies not listed on the Russian organized stock market, with related, subsidiary, affiliated companies. All companies are small and medium-sized enterprises. The subject of the study was cash flows of companies associated with the attraction, distribution and redistribution of financial resources within the affiliate structure. We observed 94 SMEs of the Republic of Tatarstan, forming 12 affiliated structures. In 92% of affiliated structures, the interests of the owners of the parent companies or the interests of the owners of key companies were violated. The following results were obtained: we studied and described two main types of affiliated structures with violated interests of the owners; we highlighted the essential features of affiliated structures in which the interests of owners are violated; we described the basic scheme of movement of financial resources indicating a violation of the owners' interests; we proposed a method of justifying the price of providing financial resources for distribution within the affiliate structure.

## KEYWORDS

Investor, Affiliates, Financial resources, Parent company, Tax effect, Cost of financial resources, Movement of financial resources, Cash flow.

## 1. INTRODUCTION

The ability to generate and properly manage financial resources is an important feature of a successful company. This is especially true in the current conditions, when the unstable situation in the money and stock markets forces companies to look for alternative sources of financing. One of the options to optimize sources of financial resources is the creation of affiliated structures where it is possible to accumulate, distribute and redistribute both own and attracted financial resources. At the same time, it is important to lay the main criterion for the movement of financial resources, namely: financial resources should be distributed within the affiliated structure in the direction of their most efficient use, allowing to improve the welfare of the owners of the affiliated structure. In practice, this criterion is not always met, which leads to a decrease in the welfare of individual groups of owners in an affiliated structure, and therefore their interests are infringed.

In domestic legislation there is no unity in the definition of the terms “affiliated parties”, “affiliated structure” (Civil Code of the Russian Federation, 1994; Federal Law on Joint-Stock Companies, 1995; Federal Law on Limited-Liabilities Companies, 1998; RSFSR Act on Competition and Limitation of Monopolistic Activity in Commodity Markets, 1991; Federal Law on the Protection of the Rights and Legal Interests of Investors on the Securities Market, 1999). For example, from a regulatory point of view, an affiliate structure can be understood as a group of legal entities that can influence the activities of legal entities engaged in entrepreneurial activity. The Civil Code interprets the term “affiliation” as “relatedness” (Civil Code of the Russian Federation, 1994).

In this matter, we will rely on the conceptual view set out in IAS 24 “Disclosure of information about related parties.” Under the affiliated parties we will understand the company associated with the company that constitutes its financial statements (Young, 2000; Avdonina *et al.*, 2016). This relationship may arise in the following situations: both companies are members of the same group of companies; one of the companies is associated with the other; companies conduct joint activities with each other, or with the same third party; one and the same individual has a

significant impact on the activities of companies, etc. By an affiliated structure, we mean the aggregate of legal entities affiliated with each other (Ankudinov & Lebedev, 2016; Akhmetov & Rysaeva, 2015; Kirpikov & Nugaev, 2016).

## 2. METHODOLOGY

The object of the study is represented by non-public companies not listed on the Russian organized stock market, with related, subsidiary, affiliated companies. All companies are small and medium-sized enterprises, in foreign practice the abbreviation SMEs is applied.

The subject of the study was cash flows of companies associated with the attraction, distribution and redistribution of financial resources within the affiliate structure (Kaspina *et al.*, 2015; Shaykheeva, 2015; Fundamentals of Entrepreneurship: the study guide, 2017).

The study identifies similar signs, which make it possible to cast doubt on the expediency of attracting, distributing and redistributing financial resources within the affiliated structure. All the studied affiliated structures are characterized by the following main features, which are, in our opinion, essential in the matter of violation of the interests of investors (owners):

- The lack of public quotes for stock prices or public assessments of ownership shares in the company;
- The presence of two or more owners of the parent (key) company;
- The presence of at least five legal entities that are part of an affiliated structure.

To the selected features we should add quite often observed lack of competence of management in complex issues related to the peculiarities of the domestic financial legislation, as well as lack of knowledge of the modern financial fundamentals of business.

In the course of the research, we identified and studied two main types of affiliated structures formed by non-public joint-stock companies and limited liability companies:

- 1) Affiliated structures consisting of a parent company, established, as a rule, in the form of a non-public joint-stock company, and a number of subsidiaries, established in the forms of limited liability companies;
- 2) Affiliated structures, consisting of several affiliated companies, created, as a rule, in the form of non-public joint-stock companies or limited liability companies with no pronounced parent company, however, consisting of one or several key companies. Key companies occupy a leading position in the affiliated structure, have the authority to make strategic and operational decisions that may affect the activities of the entire affiliate structure.

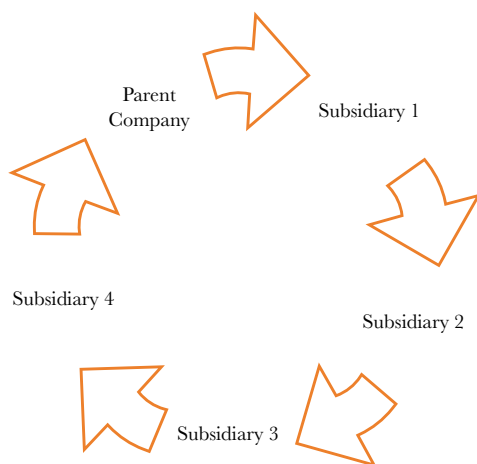
As a rule, the parent company in the form of a non-public joint-stock company, establishes a number of affiliated and subsidiary companies. One of the goals of creating, for example, subsidiaries can be vertical or horizontal integration, which will result in the achievement of additional synergistic advantages with a certain monetary value. Such integration is carried out in the interests of the owners only if the total market value of the company with its subsidiaries is higher than the value of the company without the establishment of subsidiaries. In the conditions of the modern Russian market, the justification for separating horizontally or vertically integrated subsidiaries, due solely to synergistic benefits, is questionable (Safiullin & Gubaidullina, 2018; Gurianova *et al.*, 2018).

Another goal of creating subsidiaries is to optimize the tax burden. In this case, it is possible to use transfer pricing, reorganize in order to obtain benefits for certain types of activities (for example, agriculture) or use other organizational and legal forms subject to preferential taxation; due to tax deductions (for VAT, export, etc.). The creation of such subsidiaries is carried out in the interests of the owners of the parent company if it can take advantage of the release of part of financial resources as a result of savings on tax payments.

Creating subsidiaries, companies may pursue other goals. For example, optimization of the company's management system, political considerations, etc. However, if a joint-stock company grows within one region, city, district, when it is difficult to realize any other benefits besides synergistic and tax advantages, it is reasonable for owners to demand from management a justification of the reasons to create the new subsidiaries. The creation of new subsidiaries within an affiliated group may lead to a decrease in transparency within the group, and, consequently, the inability to assess the performance of managers. Creating new subsidiaries can occur at the request of individual owners, then, one of the consequences may be infringement of the interests of other owners included in the affiliated structure.

### 3. RESULTS AND DISCUSSION

Simplified, the flow of financial resources in an affiliated structure with the participation of the parent company is shown in Figure 1.



**Figure 1.** Movement of financial resources in an affiliate structure with the participation of the parent company.

In the variant presented in Figure 1, the interests of the owners of the parent company may be violated as follows: the parent company provides the subsidiary 1 with money in the form of a low interest (or interest-free) loan, and takes, in

turn, money as an interest loan from the subsidiary 4. Redistribution of financial resources reduces the degree of informational transparency between subsidiaries. At the same time, in the corporate reporting of the parent company, the amounts issued are reflected in the composition of financial investments, and the funds received - in the form of paid long-term funding sources. If the parent company used its cash on its own, the corporate reporting amounts would be in the cash account, and there would be no increase in debt obligations. Table 1 presents the option when the parent company does not provide “non-market” lending to affiliated companies. To illustrate the example, assume that the company initially did not have paid sources of borrowed funds.

**Table 1.** Statement of financial position of the parent company without issuing funds to affiliated companies RuR.

Assets		Equity and liabilities	
PPE	500	Ordinary shares, RuR 1	900
Inventories	100		
Cash	400	Trade payables	100
<b>Total</b>	<b>1000</b>	<b>Total</b>	<b>1000</b>

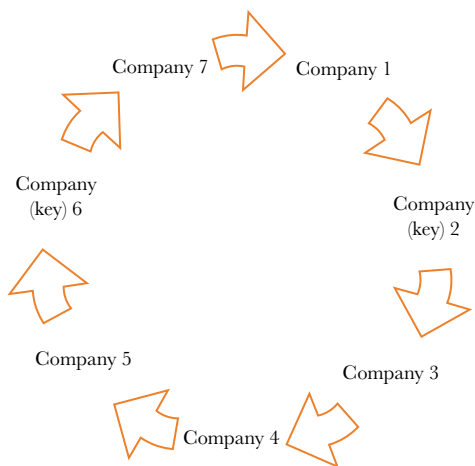
Table 2 presents the option when the parent company sends its own funds to an affiliate company under “non-market” conditions and receives them back at “market prices”. At the same time, suppose that in such a way 300 rubles are redistributed.

**Table 2.** The report on the financial position of the parent company after the redistribution of funds with the participation of affiliated companies RuR.

Assets		Equity and liabilities	
<b>PPE</b>	500	Ordinary shares, RuR 1	<b>900</b>
<b>Inventories</b>	100		
<b>Financial investments</b>	300	Long-term liabilities	<b>300</b>
<b>Cash</b>	400	Trade payables	<b>100</b>
<b>Total</b>	<b>1300</b>	<b>Total</b>	<b>1300</b>

When the above-mentioned redistribution of the most liquid assets due to unreasonable market laws leads to a distortion of corporate reporting data, and, consequently, to incorrect analytical indicators, calculated on its basis, which, in turn, may affect the adoption of investment and credit solutions, both by the owners of the company and other stakeholders.

Affiliation of companies does not always mean the allocation of the parent company. Figure 2 presents one of the options for the movement of financial resources in affiliated structures without a pronounced parent company.



**Figure 2.** Movement of financial resources in an affiliate structure without a parent company.

In the course of the study, we concluded that in the variant presented in Figure 2, the violation of the interests of the owners will occur in the same way as in the variant shown in Figure 1. Theoretically, the interests of the owners of any of the companies may suffer here, but in practice, as a rule, there is a violation of the interests of key companies' owners.

## 4. SUMMARY

It should be noted that in market conditions, the company's financial management is carried out in three main areas: management of investment projects (assets), management of sources of financing (liabilities) and management of dividend



policy. Therefore, the distribution of financial resources within the affiliate structure in substantial amounts should contribute to the achievement of the company's long-term goals. Companies assume the implementation of certain investment projects and carry out a search corresponding to the cost and volume of financial resources. Investment projects should be economically viable, i.e. lead to an increase in the welfare of the company owners. In a market economy, the attraction of financial resources for the implementation of investment projects is fee-based. This means that each new ruble attracted will cost the company a few kopecks. If the parent (or key) company has a WACC value of 18%, then, by financing affiliated companies at an effective rate of less than 18% per annum, it destroys its market value. An exception will be situations where the economic benefits from cooperation with an affiliated company, by monetary terms, will cover losses from the provision of financial resources at a "low" price.

In general, the minimum cost of financial resources for an affiliated company can be determined by the formula (1):

$$CC_{\min} = WACC - \frac{NI}{CE_{af}} \times 100\% \quad (1)$$

Where:

$CC_{\min}$ : the minimum cost of financial resources released to the affiliated company (%),

WACC: weighted average cost of capital of a company that disburses the financial resources to an affiliated company (%),

NI: is the company's annual net income from cooperation with an affiliated company (RuR),

$CE_{af}$ : capital invested in an affiliated company - the total amount of financial resources provided to an affiliated company (RuR).

Providing the affiliate company with financial resources at the minimum price ( $CC_{\min}$ ), theoretically, will not entail a negative impact on the market value of the giver.

## 5. CONCLUSIONS

During the study we observed 94 SMEs of the Republic of Tatarstan, forming 12 affiliated structures. In 92% of affiliated structures, the interests of the owners of the parent companies or the interests of the owners of key companies were violated. Consequently, the problem of protecting the interests of investors in affiliated SMEs is extremely acute today.

The need to protect the interests of investors in the movement of financial resources is primarily due to the low degree of transparency of information provided by a non-public SMEs to its owners regarding cash flows and their distribution and redistribution within an affiliated group of companies.

Thus, based on our study, the following results were obtained:

- We studied and described two main types of affiliated structures with the violated interests of the owners;
- We highlighted the essential features of affiliated structures in which the interests of owners are violated;
- We described the basic scheme of movement of financial resources indicating a violation of the interests of owners;
- We proposed a method of justifying the price of providing financial resources for distribution within the affiliate structure.

In our research, we were faced with the fact that none of the available databases contain information about affiliated structures in the planes we need, which significantly limited our research. Nevertheless, we obtained the results described in this article, which can be a subject for discussion, as well as a starting point for further research.

## 6. ACKNOWLEDGEMENTS

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