Specifics of Consolidation from the Point of View of the Statutory Auditor in the Event of Loss of Control

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Abstract. The loss of control of a parent company over the subsidiary is a very specific area of consolidation, which, however, must also be addressed by the statutory auditor. This is called deconsolidation. The aim of this paper is to analyze the process of deconsolidation and reflect it on two practical examples. We will first analyze the specifics of deconsolidation from the point of view of the statutory auditor and then reflect them on practical examples, dealing with two cases - the sale of a subsidiary, which at the time of sale has higher equity than at the time of acquisition and at the time of sale lower equity than at the time of acquisition of the share. We will show how to proceed in these cases, as we will be working with the data on the subsidiary as of the date when the parent company will no longer have control over the subsidiary. Based on the solution of examples, which will be reflected numerically and in tables that will show the individual data in the individual and consolidated financial statements, we will see how deconsolidation will affect the consolidated financial statements in individual cases.

Keywords: loss of control, consolidated financial statements, deconsolidation

JEL classification: *M 41, M 42*

1 Introduction

The tasks of the statutory auditor also include the verification of deconsolidation. These are consolidation adjustments in such a case, if the parent company loses control over the subsidiary, which may happen because of the liquidation of the subsidiary or also, for example, the sale of the share, or part of it, it is the so-called deconsolidation. [2] In practice, the statutory auditor often encounters the incompleteness or omission of deconsolidation. [11] Therefore, it is very important to verify this fact. We can speak of a properly executed deconsolidation procedure if the company disposes of shares in subsidiaries, which consist in repeating the last consolidation of capital and the subsequent disposal of the assets and liabilities of the subsidiary. [12] However, the entire consolidation process must be in accordance with International Financial Reporting Standard IFRS 10 - Consolidated Financial Statements (hereinafter "IFRS 10"). [8]

In this paper, we focus on the sale of the entire share in the subsidiary, from which the parent company may incur a profit or loss. It depends on whether the subsidiary has equity higher at the time of the sale than at the time of the acquisition of the share by the parent company - then we are talking about the sale of a profitable subsidiary. Otherwise, if the subsidiary has less equity at the time of the sale than at the time of the acquisition of the shareholding by the parent, it is the sale of the loss-making subsidiary. We will reflect both cases on practical examples. [7]

2 Methodology

The aim of this paper is to analyze the deconsolidation process. On two practical examples we will show how to perform deconsolidation correctly in practice. There is a very important fiction of the legal unit. [1] The point is that we will be working with the data on the subsidiary, even if by that date the parent company no longer has control over the subsidiary. It is necessary to maintain continuity and take into account the data on the subsidiary for the part of the period when the parent company still had control over the subsidiary. [4] It is also necessary to take into account, for example, the retained earnings of the subsidiary's previous years. If we do not carry out deconsolidation and do not take into account the data on the subsidiary, the results would be skewed. The consolidated profit or loss would not be adjusted by the profit or loss of the subsidiary, which would also lead to the recognition of an incorrect profit or loss. [9]

3 Loss of control of a parent over a subsidiary

International Financial Reporting Standard IFRS 10 deals with consolidation only very marginally. [8] Under IFRS 10, in the event of the loss of control of a subsidiary, the parent ceases to recognize the assets, including goodwill and liabilities of the subsidiary from the consolidated statement of financial position. [3] The parent recognizes all investments retained in the former subsidiary at fair value at the time of the loss of control, which it then recognizes with the subsidiary's liabilities, if any. The parent subsequently recognizes a gain or loss that relates to the loss of control of the subsidiary. The parent recognizes, if any, the consideration resulting from the loss of control measured at fair value. Furthermore, all items that are recognized in other comprehensive income related to a subsidiary are recognized in profit or loss, or in profit or loss from prior periods. [9] In the following sections, we will focus on simplified practical examples in the field of deconsolidation, in which we will abstract from goodwill, profit from a bargain purchase and non-controlling interests.

3.1 Loss of control of a profitable subsidiary

About the loss of control, the so-called a profitable subsidiary exists when the subsidiary has a higher equity at the time of the sale than at the time when the parent acquired the shares in the subsidiary. The equity of the subsidiary has finally increased, so it is a profit. [12]

We will then explain the consolidation in the event of a loss of control of a profitable subsidiary on a practical example.

Assume that company A is the parent company, which acquired a 100% share in subsidiary Z on 31 December 2018. This is a cash contribution in the amount of € 800,000. The share capital of the subsidiary was also worth € 800,000. The share in the subsidiary was consolidated using the full consolidation method as at 31 December 2018 and 31 December 2019. Parent company A sold on 30 June 2020 the entire share in subsidiary Z in the amount of € 800,000. In 2019 and also in the first half of 2020, the subsidiary Z reported costs, revenues and profit. In our example, we will also abstract from liabilities and other components of assets. We assume that parent company A also has shares in other subsidiaries and thus carries out an activity that consists mainly in the ownership of financial assets.

In the tables we can see data from the individual financial statements of parent company A, data from the individual financial statements of subsidiary Z, consolidation adjustments, deconsolidation and finally the resulting consolidated data. [6] All data are given in thousand €.

Table 34. Consolidation as at 31 December 2018

Balance sheet	A	Z	Consolidation	Deconsolidation	Result
Total assets	2,800	800	- 800		2,800
Financial assets	800		- 800		
Cash	2,000	800			2,800
Equity	2,800	800	- 800		2,800
Share capital	1,200	800	- 800		1,200
Retained earnings	1,300				1,300
Profit + / Loss -	300				300
Income statement	**A**	**Z**	**Consolidation**	**Deconsolidation**	**Result**
Revenue	800				800
Expenses	- 500				- 500
Financial income					
Financial expenses					

Profit + / Loss -	300				300

Source: own processing

In Table 1 we can see the first consolidation of capital as at 31 December 2018. In this case, it was the elimination of the financial assets of the parent company "A" and the share capital of the subsidiary company "Z". [3]

In Table 2 we see the consolidation of the subsidiary "Z" as at 31 December 2019.

Table 2. Consolidation as at 31 December 2019

Balance sheet	**A**	**Z**	**Consolidation**	**Deconsolidation**	**Result**
Total assets	3,200	1,000	- 800		3,400
Financial assets	800		- 800		
Cash	2,400	1,000			3,400
Equity	3,200	1,000	- 800		3,400
Share capital	1,200	800	- 800		1,200
Retained earnings	1,600				1,600
Profit + / Loss -	400	200			600
Income statement	**A**	**Z**	**Consolidation**	**Deconsolidation**	**Result**
Revenue	1,000	550			1,550
Expenses	- 600	- 350			- 950
Financial income					
Financial expenses					
Profit + / Loss -	400	200			600

Source: own processing

In the first step, we repeated the elimination of the financial assets of the parent company "A" and the share capital of the subsidiary company "Z". We repeated this step to maintain continuity. We also calculated profit or loss, while the subsidiary "Z" generated a profit of € 200,000. This profit is part of the consolidated profit or loss. The consolidated profit is thus a profit of € 600,000, which includes the profit of the parent company of € 400,000 and the profit of the subsidiary of € 200,000.

Table 3 includes information on the subsidiary "Z" as at 30 June 2020, because until then it was part of the consolidated group and this fact must be taken into account as at 31 December 2020. These data are very important for proper consolidation. The clearing data therefore also include the data of the subsidiary on the date of disposal, or on the date of loss of control of the subsidiary by the parent company. Furthermore, Table 3 includes the data of the parent company "A" for the whole year 2020, in our case as at 31 December 2020.

Table 3. Consolidation as at 31 December 2020

Balance sheet	A	Z	Consolidation	Deconsolidation	Result
Total assets	3,500	1,200		- 1,200	3,500
Financial assets					
Cash	3,500	1,200		- 1,200	3,500
Equity	3,500	1,200	- 800	- 400	3,500
Share capital	1,200	800	- 800		1,200
Retained earnings	2,000	200			2,200
Profit + / Loss -	300	200		- 400	100
Income statement	**A**	**Z**	**Consolidation**	**Deconsolidation**	**Result**
Revenue	1,200	800			2,000
Expenses	- 900	- 600			- 1,500
Financial income	800				800
Financial expenses	- 800			- 400	- 1,200
Profit + / Loss -	300	200		- 400	100

Source: own processing

The first step we have taken is to repeat the consolidation of capital. We eliminated the item of the share capital of the subsidiary (amount of € 800,000), while we no longer eliminated the share in the subsidiary included in the financial assets, because at this date it is no longer part of the parent company's assets, as the parent company lost control as at 30 June 2020 over the subsidiary. The items of retained earnings, which in our case represent the value of € 200,000 and the profit for the first half of 2020, which also represents the value of € 200,000 are also part of the consolidated equity.

Now, we come to the part where we talk about deconsolidation. The difference between the assets of the subsidiary and the liabilities of the subsidiary reduced by the eliminated items of the equity of the subsidiary increases or decreases the financial cost of the parent company related to the sale of the share in the subsidiary. As we can see, in our case we eliminate assets in the amount of € 1,200,000 upon deconsolidation and the subsidiary did not have any liabilities, which means that the difference between the eliminated assets and liabilities remains € 1,200,000. If we reduce this difference by the eliminated share capital, which was € 800,000, we will have a difference of € 400,000.

We will subsequently reduce profit or loss by this amount and increase the cost of the sold share of the subsidiary.

The decrease in profit or loss is because the amount of € 400,000 includes the profit of the subsidiary for 2019 in the amount of € 200,000 and the profit of the subsidiary for the first half of 2020 also in the amount of € 200,000. Profit or loss of the sale of the parent company's share in the subsidiary is zero, because the sales for the sold share is € 800,000 and the cost of the sold share is the same, because it represents the purchase price of the sold share in the subsidiary. However, given that during the parent's control over the subsidiary, its equity increased by € 400,000, we can see that the consolidated financial statements show a loss from the sale of a share in the subsidiary of € 400,000.

In Table 3, we see the data in the consolidated financial statements, which include all data on the parent company. However, the retained earnings of the subsidiary as at 31 December 2019 are also taken into account here and the profit of the subsidiary as at the date of loss of control - as at 30 June 2020. Retained earnings of the parent and subsidiary as at 31 December 2019 amounted to € 1,600,000 and the profits of these companies for 2019 - the parent company for 2019 achieved a profit of € 400,000 and the subsidiary for € 200,000. The sum of these three amounts represents retained earnings in the consolidated financial statements as at 31 December 2020. Subsequently, we calculate the consolidated profit or loss. We calculate the profit of the parent company for the whole year 2020 (amount € 300,000) and the subsidiary for the first half of 2020 (amount € 200,000), while deducting the loss from the sale of a share in the subsidiary in the amount of € 400,000. This is a loss from the sale of a share in a subsidiary because the equity of the subsidiary at its inception was in the value of the deposit – in the amount of € 800,000. The equity of the subsidiary as at 30 June 2020 is in the amount of € 1,200,000. This means that the value of the sold share of the subsidiary was in the amount of € 1,200,000, but the sales for the sold subsidiary were in the amount of € 800,000. The difference € - 400,000 is reported as a loss, which is the difference between financial income and financial expenses, as we can see in Table 3. The costs and revenues in the consolidated financial statements also represent the costs and revenues of the parent company for the whole of 2020, while for the subsidiary it is only for the first half of 2020.

As mentioned, the subsidiary had higher equity at the time of the sale than at the time when the parent acquired the shares in the subsidiary. We can therefore talk about the loss of control of the so-called profitable subsidiary.

3.2 Loss of control of a loss-making subsidiary

About the loss of control, the so-called a loss-making subsidiary is involved if at the time of the sale, the subsidiary has a lower equity than it had at the time of the acquisition of the parent company's share in the subsidiary. The equity of the subsidiary has therefore ultimately decreased, a loss. [12]

In Table 4 we can see the first consolidation of capital as at 31 December 2018.

Table 4. Consolidation as at 31 December 2018

Balance sheet	A	Z	Consolidation	Deconsolidation	Result
Total assets	2,800	800	- 800		2,800
Financial assets	800		- 800		
Cash	2,000	800			2,800
Equity	2,800	800	- 800		2,800
Share capital	1,200	800	- 800		1,200
Retained earnings	1,300				1,300
Profit + / Loss -	300				300
Income statement	**A**	**Z**	**Consolidation**	**Deconsolidation**	**Result**
Revenue	800				800
Expenses	- 500				- 500
Financial income					
Financial expenses					
Profit + / Loss -	300				300

Source: own processing

Again, we eliminated the financial assets of the parent company and the share capital of the subsidiary.

In Table 5 we can see the consolidation of the subsidiary "Z" as at 31 December 2019.

Table 5. Consolidation as at 31 December 2019

Balance sheet	A	Z	Consolidation	Deconsolidation	Result
Total assets	3,200	650	- 800		3,050
Financial assets	800		- 800		
Cash	2,400	650			3,050
Equity	3,200	650	- 800		3,050
Share capital	1,200	800	- 800		1,200
Retained earnings	1,600				1,600

Profit + / Loss -	400	- 150			250
Income statement	**A**	**Z**	**Consolidation**	**Deconsolidation**	**Result**
Revenue	1,000	650			1,650
Expenses	- 600	- 800			- 1,400
Financial income					
Financial expenses					
Profit + / Loss -	400	- 150			250

Source: own processing

We repeated the elimination of the financial assets of the parent company and the share capital of the subsidiary. The consolidated profit or loss is a profit of € 250,000 which includes the profit of the parent company in the amount of € 400,000 and the loss of the subsidiary in the amount of € 150,000.

In Table 6 we see data for the parent company as at 31 December 2020, respectively for the whole year 2020, while the data of the subsidiary are only for the first half of 2020, respectively as at 30 June 2020, because as at 30 June 2020, the parent company lost control over the subsidiary

Table 6. Consolidation as at 31 December 2020

Balance sheet	**A**	**Z**	**Consolidation**	**Deconsolidation**	**Result**
Total assets	3,500	490		- 490	3,500
Financial assets					
Cash	3,500	490		- 490	3,500
Equity	3,500	490	- 800	310	3,500
Share capital	1,200	800	- 800		1,200
Retained earnings	2,000	- 150			1,850
Profit + / Loss -	300	- 160		310	450
Income statement	**A**	**Z**	**Consolidation**	**Deconsolidation**	**Result**
Revenue	1,200	600			1,800
Expenses	- 900	- 760			- 1,660
Financial income	800				800
Financial expenses	- 800			310	- 490

Profit + / Loss -	300	- 160		310	450

Source: own processing

We repeated the elimination of the share capital of the subsidiary, while the elimination of financial assets that contain the share of the parent company in the subsidiary was no longer eliminated, as this share no longer exists as at 31 December 2020. The retained earnings are also part of the consolidated equity. The accumulated loss of the subsidiary is in the amount of € - 150,000 and the loss for the first half of 2020 is in the amount of € - 140,000.

Subsequently, we can perform deconsolidation. The difference between the assets and liabilities of the subsidiary reduced by the eliminated items of equity of the subsidiary will reduce or increase the financial expenses of the parent company, which is related to the sale of shares in the subsidiary. In our case, we eliminate assets in the amount of € 490,000 upon consolidation and this company did not have any liabilities, so the difference is € 490,000. We will reduce this amount by the eliminated share capital, which was € 800,000. We will have a negative difference € - 310,000. We will subsequently reduce the cost of the sold share of the subsidiary by this amount and increase the economic result.

The increase in profit or loss arises because the amount of € - 310,000 includes the loss of the subsidiary for 2019, which was in the amount of € - 150,000 and the loss of the subsidiary for the first half of 2020 in the amount of € - 160,000. As the revenues from the sold share of the subsidiary are in the same amount as the expenses of the sold share, the profit or loss from the sale of the share is zero. During the parent's control over the subsidiary, the subsidiary's equity decreased by € 310,000. The consolidated financial statements show a profit on the sale of a share in a subsidiary in the amount of € 310,000.

In Table 6, we see the data in the consolidated financial statements, which also include the data of the subsidiary up to the date on which the parent company lost control of the subsidiary. Retained earnings in the consolidated financial statements represent the sum of retained earnings of the parent and subsidiary as at 31 December 2019 in the amount of € 1,600,000, the profit of the parent for 2019 in the amount of € 400,000 and the loss of the subsidiary for 2019 in the amount of € - 150,000.

We calculate the consolidated profit or loss as follows: from the profit of the parent company for the whole year 2020, which represents the amount of € 300,000, we deduct the loss of the subsidiary for the first half of 2020, which represents the amount € - 160,000. It is a profit from the sale of a share in a subsidiary because the equity of the subsidiary at its inception was in the amount of the deposit, which represents the amount of € 800,000 and the equity of the subsidiary as at 30 June 2020 is in the amount of € 490,000. This means that the value of the sold share of the subsidiary was in the amount of € 490,000 and the sales for the sold share was in the amount of € 800,000, the difference in the amount of € 310,000 is reported as a profit. It is the difference between financial income and financial expenses. Other financial expenses and income items in the consolidated financial statements represent the expenses and income of the subsidiary only for the first half of 2020 and the parent company for the whole of 2020.

We see that the subsidiary had lower equity at the time of the sale than at the time the parent acquired the shares in the subsidiary, so we are talking about the loss of control of the so-called loss-making subsidiary.

4 Conclusion

In practice, the implementation of deconsolidation is very often incorrect or omitted altogether. It is a very complex process that the statutory auditor must oversee. [10] As the parent no longer has control over the subsidiary as at 31 December, this may lead to the subsidiary not being taken into account at all at that date, so that the parent and subsidiary data are no longer aggregated, no consolidation will take place. This may be because the parent no longer recognizes that interest in the subsidiary as a financial asset because it no longer has control over it. This may therefore lead to the complete omission of deconsolidation. However, this is a mistake, it is very important to take the subsidiary into account as of this date in order to carry out the consolidation correctly. [5]

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