The nature and significance of consolidation procedures in the event of the loss of control of the parent company over the subsidiary

Petra Krišková[1], Ján Užík[2]

[1] University of Economics in Bratislava
Faculty of Economic Informatics, Department of Accounting and Auditing
Dolnozemská cesta 1/b, 852 35 Bratislava, Slovakia
E-mail: petra.kriskova@euba.sk

[2] University of Economics in Bratislava
Faculty of Economic Informatics, Department of Accounting and Auditing
Dolnozemská cesta 1/b, 852 35 Bratislava, Slovakia
E-mail: jan.uzik@euba.sk

Abstract: Deconsolidation is the process of consolidation adjustments that need to be made in the event of the loss of control of a parent company over a subsidiary because of the sale of a share or part of it, the liquidation of a subsidiary, and so on. The consolidation process should be designed in accordance with International Financial Reporting Standard IFRS 10 - Consolidated Financial Statements and in general in accordance with the fiction of the legal entity (Kubascikova, Z., Paksiova, R. 2015). The article deals with the deconsolidation of the sold share in a subsidiary by means of the example of the sale of a profitable subsidiary (the subsidiary has higher equity at the time of sale than at the time of acquisition). In the event of an increase in the equity of a subsidiary, deconsolidation will result in an increase in the cost of selling the interest in the subsidiary (compared to the cost of sale recognized in the parent’s separate financial statements) and vice versa. The omission of consolidation may result in a material error in the consolidated data for the period in which control of the subsidiary is lost.

Keywords: *Consolidated financial statements, consolidation, deconsolidation, control, loss of control*

JEL codes: M42

1 Introduction

In practice, we often encounter incorrect implementation of deconsolidation or its complete omission. Therefore, in this contribution, we illustrate with a simple example the importance of the proper conduct of deconsolidation operations and their impact on the data reported in the consolidated financial statements. We speak of deconsolidation in the case of disposal of shares in subsidiaries, which consists in the repetition of the last consolidation of capital and the subsequent disposal of assets and liabilities of the subsidiary. It is mainly the sale of a share in a subsidiary or disposal due to the liquidation of the subsidiary. In the case of a sale of a share, the parent's separate financial statements show the proceeds from the sale of the share and the costs associated with the sale, under normal circumstances, this is the cost of the sold share. The difference between revenue and the value of the discarded share is a profit or loss from the sale of the share. These data are then also part of the aggregated data for the accounting period in which the share was eliminated.

2 Methodology and Data

As part of the International Accounting Standard IFRS10, the deconsolidation is only briefly mentioned (Juhaszova, Z., Markovic, P., Mokosova, D. (2014), (Prochazka, D., Molin, J. 2016). In the event of loss of control of a subsidiary, the parent ceases to recognize the assets (including goodwill) and liabilities of the subsidiary, as well as the non-controlling interests in the subsidiary, at the time of loss of control. The parent company reports any investments retained in the former subsidiary at the time of the loss of control at their real value, which it then settles against any liabilities of the subsidiary. The parent company shall recognize a profit or loss arising from the loss of control. It also recognizes the equivalent (if any) for the loss of control measured at fair value. It recognizes within profit or loss (reclassified to profit or loss) or within the outcome of the previous periods, all items recognized in other comprehensive income related to the subsidiary (Tumpach, M., Mazikova, K., Kucekova, M. 2015).

3 Results and Discussion

In the following example, the basic (maximum simplified) assumptions will apply: As of 31 December 2019, the parent company M acquired a 100% share in subsidiary D through a cash deposit in the amount of EUR 1,000,000. The capital of the subsidiary was EUR 1,000,000. Thus, in the examples, we do not expect the creation of goodwill, or a profit on the purchase of a share, or non-controlling interests (Ondrusova, L., Parajka, B. 2014). As of 31 December 2019, and 31 December 2020, the share in the subsidiary was consolidated using the full consolidation method. On 31 March 2021, parent company M sold its entire share in subsidiary D for EUR 1,000, 000. Subsidiary D reported revenues, costs, and profit in 2020 as well as in the first quarter of 2021. We assume that the parent company also has shares in other subsidiaries. We abstract from liabilities and other components of assets (Vochozka, M., Rowland, Z., Suler, P. 2019). The following data are in the individual columns in the tables below: individual accounting data of the parent company for the given year, individual accounting data of the subsidiary for the given year, consolidation adjustments, deconsolidation, and the resulting - consolidated data.

Table 1 Consolidation as at December 31, 2019 (in thousands of EUR)

Balance sheet	M	D	Consolidation	Deconsolidation	Result
Total assets	3 500	1 000			3 500
Financial assets	1 000		-1 000		
Cash	2 500	1 000			3 500
Equity	3 500	1 000			3 500
Share capital	1 500	1 000	-1 000		1 500
Reatained earnings	1 800				1 800
Profit + / Loss -	200				200

Income statement	M	D	Consolidation	Deconsolidation	Result
Revenue	500				500
Expenses	-300				-300
Financial Income					
Financial expenses					
Profit + / Loss -	200				200

Source: own processing

In Table 1, the share in the subsidiary was consolidated for the first time as at 31 December 2019. The consolidation of capital consisted only in the elimination of the financial assets of the parent company (share in the subsidiary) and the share capital of the subsidiary (Mateasova, M. 2016).

Table 2 Consolidation as at December 31, 2020 (in thousands of EUR)

Balance sheet	M	D	Consolidation	Deconsolidation	Result
Total assets	3 900	1 600			4 500
Financial assets	1 000		-1 000		
Cash	2 900	1 600			4 500
Equity	3 900	1 600			4 500
Share capital	1 500	1 000	-1 000		1 500
Reatained earnings	2 000				2 000
Profit + / Loss -	400	600			1 000

Income statement	M	D	Consolidation	Deconsolidation	Result
Revenue	900	2 000			2 900
Expenses	-500	-1 400			-1 900
Financial Income					
Financial expenses					
Profit + / Loss -	400	600			1 000

Source: own processing

In Table 2, subsidiary D was consolidated as of December 31, 2020 for the second time. The consolidation of capital consisted in the repetition of the elimination of the financial assets of the parent company (share in the subsidiary) and the share capital of the subsidiary. The profit or loss of the subsidiary for 2020, a profit of EUR 600,000 is part of the consolidated profit or loss. The consolidated profit or loss of EUR 1 000, 000 is therefore the sum of the profit or loss of the parent and subsidiary.

Table 3a Consolidation as at December 31, 2021 (in thousands of EUR)

Balance sheet	M	D*	Consolidation	Deconsolidation	Result
Total assets	4 100	1 660			4 100
Financial assets					
Cash	4 100	1 660		-1 660	4 100
Equity	4 100	1 660			4 100
Share capital	1 500	1 000	-1 000		1 500
Reatained earnings	2 400	600			3 000
Profit + / Loss -	200	60		-660	-400

Income statement	M	D*	Consolidation	Deconsolidation	Result
Revenue	800	500			1 300
Expenses	-600	-440			-1 040
Financial Income	1 000				1 000
Financial expenses	-1 000			-660	-1 660
Profit + / Loss -	200	60			-400

Source: own processing

(* individual data of the subsidiary are as of 31.3.2021, resp. for the first quarter of 2021)

We see the correctly performed deconsolidation in table 3a. The aggregate data include the actives and passives of the subsidiary as of the date of disposal of the share, as of the date of its sale, thus to 31.3.2021. The costs and revenues of the subsidiary are aggregated for the period from 1.1.2021 to 31.3.2021 when the parent company still had control over the subsidiary. The data of the parent company are for the whole year 2021. The repetition of the capital consolidation carried out in the previous period consists in the elimination of those items of the subsidiary's equity that were eliminated in the previous period, so only the share capital of EUR 1,000,000 (financial assets representing a share in the subsidiary are not eliminated. Because as of 31.12.2021 it is no longer part of the property of the parent). Retained earnings of the subsidiary in the amount of 600,000 but also its profit for the first quarter of 2021 are part of consolidated equity in the same items, thus retained earnings and profit for 2021. Consolidation consists of eliminating the assets of the subsidiary, the liabilities of the subsidiary (in our example they are zero). The difference between them, reduced by the eliminated equity items of the subsidiary (thus the difference between the eliminated assets and all eliminated liabilities), reduces or increases the financial cost associated with the sale of the interest in the subsidiary. In our example, deconsolidation eliminates assets in the amount of EUR 1,660,000. The liabilities of the subsidiary are nil, that is the difference between the eliminated assets and liabilities is EUR 1,660,000. If we reduce this difference by the eliminated capital (assets in the amount of EUR 1,660,000 and liabilities in the amount of EUR 1,000,000 were eliminated), the difference is EUR 660,000. The profit and loss will decrease by the amount of EUR 660,000 and the cost of the sold share in the subsidiary will increase. Why? Because the amount of EUR 660,000 represents the profit of the subsidiary for 2020 in the amount of EUR 600,000 and the profit of the subsidiary for the first quarter of 2021 in the amount of EUR 60,000. The separate financial statements show the profit or loss from the sale of a stake in a subsidiary in the amount of 0. The revenue for the sold share is EUR 1,000,000 and the cost of the sold share (acquisition price of the sold share) is also EUR 1,000,000. The consolidated financial statements show a loss of EUR 660,000 from the sale of a stake in a subsidiary because, during the period of control over the subsidiary, its equity increased by exactly EUR 660, 000. If we look in detail at the individual data of the consolidated financial statements, the assets consist of the assets of the parent company as of 31 December 2021, also the capital in the consolidated financial statements consists only of the capital of the parent company. Retained earnings in the consolidated financial statements consist of retained earnings of the parent company and subsidiary, which were reported as of 31.12.2020. It is the amount of EUR 2,000,000 and from the profits of both companies for the year 2020 - the parent company for the year 2020 reported a profit of EUR 400, 000 and the subsidiary a profit of EUR 600,000. The consolidated profit was reported in the amount of EUR -400,000. This is the sum of the profit of the parent company for the year 2021 in the amount of EUR 200,000 the profit of the subsidiary for the first quarter of 2021 in the amount of EUR 60,000 and the loss from the sale of the share in the subsidiary in the amount of EUR -660,000. Why are we talking about a loss from the sale of a subsidiary in the amount of EUR 660,000 ? Because the assets of the subsidiary at its establishment consisted of the value of the parent company's deposit in the amount of EUR 1,000,000. The substance of the subsidiary as of 31 March 2021, so the value of what was sold, consisted in the equity of the subsidiary in the amount of EUR 1,660,000. As the sales for the subsidiary sold amounted to EUR 1,000,000 we report a loss of EUR 660,000. This is how financial income and financial expenses are reported in the consolidated financial statements. Furthermore, the consolidated revenues include the revenues of the parent company for the year 2021 and the revenues of the subsidiary for the first quarter of 2021. Also, the consolidated cost of sales consists of the parent company's costs for 2021 and the subsidiary's costs for the first quarter of 2021.

Table 3b Consolidation as at December 31, 2021 (in thousands of EUR)

Balance sheet	M	D	Consolidation	Deconsolidation	Result
Total assets	4 100				4 100
Financial assets					
Cash	4 100				4 100
Equity	4 100				4 100
Share capital	1 500				1 500
Reatained earnings	2 400				2 400

Profit + / Loss -	200				200

Income statement	M	D	Consolidation	Deconsolidation	Result
Revenue	800				800
Expenses	-600				-600
Financial Income	1 000				1 000
Financial expenses	-1 000				-1 000
Profit + / Loss -	200				200

Source: own processing

We will point out the frequent omission of deconsolidation in table 3b. As the parent company no longer owns a share in the subsidiary as of December 31, 2021, it does not show this share in the financial assets, this fact leads to the idea of not aggregating or consolidating anything in respect of the subsidiary. The misstatement of the consolidated data then consists mainly in the non-recognition of a loss on the sale of a subsidiary, incorrectly reported retained earnings (provided that profits are recognized for the previous period within retained earnings this item should be EUR 3,000,000. This is the sum of retained earnings reported in the previous period in the amount of EUR 2,000,000 and profit for the previous year in the amount of EUR 1,000,000. Furthermore, the consolidated sales as well as the costs of sales lack the revenue and costs of the subsidiary for the first quarter of 2021, hence for the period when the subsidiary was still under the control of the parent company. Therefore, even in the consolidated profit or loss, the subsidiary's profit for the first quarter is not summarized.

Conclusions

It is important to note that in the consolidated financial statements, the fiction of a legal entity applies and therefore the sale of an interest in a subsidiary is understood as the sale of part of the enterprise (Gluzova, T. 2015). The most significant difference compared to the recognition of the sale of a share in the separate financial statements is the consideration of changes in the equity of a subsidiary that occurred from the time of acquisition to the time of disposal of the share. These changes in the equity of the subsidiary do not have to be reported in the separate financial statements or may be reported otherwise (Juhaszova, Z., Domoracka, D. 2015). Changes in equity in the event of an increase in the equity of a subsidiary will increase the cost of disposing of the interest. For example, the subsidiary’s profits were included in the consolidated data for the period in which the subsidiary was part of a group and consolidated using the full consolidation method. These profits, unlike the parent’s separate financial statements, will increase the costs associated with disposing of the interest. In the case of losses (reduction of equity) of a subsidiary, these losses may also be reflected in the parent’s separate financial statements in the form of impairment of financial assets (Tumpach, M. 2016).

Acknowledgments

The article is processed as an output of the grant task APVV-16-0602 Increasing the relevance of accounting information in the Slovak Republic - from costs to value.

References

Gluzova, T. (2015). Consolidation Exemptions under IFRS. In 16th Annual conference on finance and accounting, ACFA PRAGUE, vol. 25, no., pp. 32-40.
Juhaszova, Z., Domoracka, D. (2015). Premiums earned in the financial statements. In Financial Management of firms and financial institutions: 10th International scientific conference, PTS I-IV., pp. 479-483.

Juhaszova, Z., Markovic, P., Mokosova, D. (2014). Fair value and its importance for financial decision-making. In IFRS: global rules & local use. International scientific conference. IFRS: global rules & local use: proceedings of the 2nd International scientific conference, Prague : Anglo-American University, pp. 64-69

Kubascikova, Z., Paksiova, R. (2015). Impact of accounting standards on the results of financial analysis. In IFRS: global rules & local use, 2015, pp. 150-155.

Mateasova, M. (2016). Capital stock in limited companies according to legislation in Slovakia. In Ucetnictvi a auditing v procesu svetove harmonizace, pp. 129-133.

Ondrusova, L., Parajka, B. (2014). The Revaluation of assets and liabilities at fair value in merger. In Managing and Modelling of Financial Risks. international scientific conference. Managing and Modelling of Financial Risks: 7th International Scientific Conference: 8th-9th September 2014 Ostrava, Czech Republic : proceedings. - Ostrava : VŠB - Technical University of Ostrava, pp. 577-581.

Prochazka, D., Molin, J. (2016). Book-tax conformity: The review of recent research and its implication for the IFRS adoption in Europe. In Ejournal of tax research, vol. 14, no. 1, pp. 96-118.

Tumpach, M. (2016). Misapplications of Rules for the Exchange Rate Differences by Slovak IFRS Adopters. In Managing and modelling of financial risks 8th International scientific conference proceedings, pp. 1016-1021

Tumpach, M., Mazikova, K., Kucekova, M. (2015). Boilerplate reporting used by Slovak IFRS submitters. In Financial management of firms and financial institutions: 10th International scientific conference, pp. 1334-1339.

Vochozka, M., Rowland, Z., Suler, P. (2019). The specifics of valuating a business with a limited lifespan. In Ad Alta-journal of interdisciplinary research, pp. 339-345.

IFRS 10. *Consolidated financial statements.* IASB, 2021.