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"Establishment of the Guidelines of the Accounting Standards Board"
Annex 11

ASBG 11 BUSINESS COMBINATIONS AND ACCOUNTING FOR SUBSIDIARIES AND ASSOCIATES

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OBJECTIVE AND BASIS FOR PREPARARTION

1. The objective of this Accounting Standards Board's guideline ASBG 11 "*Business Combinations and Recognition of Subsidiaries and Associates*" is to set out the rules for the accounting for business combinations and the accounting for subsidiaries and associates in the consolidated financial statements and those of the parent entity (hereinafter also *the financial statement*) prepared in accordance with the Estonian financial reporting standard. Estonian financial reporting standard is a body of financial reporting requirements directed at the public and based on the internationally accepted accounting and reporting principles, which principal requirements are established by the Accounting Act and which is specified by a regulation of the minister responsible for the area established on the basis of subsection 34 (4) of the Accounting Act (hereinafter *guideline of the Standards Board* or for short *ASBG*).

2. ASBG 11 is based on IFRS for SMEs sections 9 "*Consolidated and Separate Financial Statements*", 14 "*Investments in Associates*", 15 "*Investments in Joint Ventures*", 19 "*Business Combinations and Goodwill*", 22 "*Liabilities and Equity*" and 30 "*Foreign Currency Translation*" and on concepts defined in section 2 "*Concepts and Pervasive Principles*" and the "*Glossary of Terms*". The guideline contains references to the specific paragraphs of IFRS for SMEs that the requirements of the guideline are based on. The comparison of ASBG 11 with IFRS for SMEs is presented in clauses 104-110. In areas that are not specified by a particular accounting policy of ASBG 11 but that are covered by IFRS for SMEs, it recommended to abide by the accounting policy described in IFRS for SMEs.

SCOPE

3. ***ASBG 11 "Business Combinations and Accounting for Subsidiaries and Associates" shall be implemented:***

> ***(a) in the accounting for business combinations in consolidated financial statements (clauses 11-59);***
> ***(b) in the preparation of consolidated financial statements (clauses 65-85); and***
> ***(c) in accounting for subsidiaries and associates in consolidated financial statements (clauses 60-64 and 86-101).***

4. This guideline shall be applied first and foremost to the acquisition of for-profit subsidiaries and associates and to the subsequent measurement in the financial statements of the investor. The policies described in this guideline shall also be applied to the acquisition and subsequent measurement of non-profit organisations and institutions in the financial statements of the investor to the extent that this guideline does not contradict the legislation regulating the accounting of these accounting entities and ensures true and fair presentation.

DEFINITIONS

5. ***The following terms are used in this guideline with the meanings specified:***

***Business combination** is an economic transaction, as a result of which:*

> **(a)** ***an entity gains control over another company (i.e. by acquisition of a sufficient number of shares of another entity) provided that the acquired entity comprises one or more business activities; or***
>
> **(b)** ***one entity acquires the assets or liabilities or the net assets or their part of another entity or business and takes over the business related to these assets or liabilities or net assets. (IFRS for SMEs 19.3)***

***Control** is the power to decide on the financial and business policies of another entity (subsidiary). (IFRS for SMEs 9.4, 19.9).*

***Significant influence** is the power to participate in the financial and business policy decisions of the investee (associate), without having control over those decisions. (IFRS for SMEs 14.3).*

***An associate** is an entity over which an investor has significant influence and that is not a subsidiary of the investor. (IFRS for SMEs 14.2).*

***Subsidiary** is an entity, over which another entity (parent entity) has control. (IFRS for SMEs 9.4).*

***A parent entity** is an entity that has one or more subsidiaries. (IFRS for SMEs Glossary of Terms).*

***A group** is a parent entity and all its subsidiaries. (IFRS for SMEs Glossary of Terms)*

***Consolidated financial statements** are the financial statements of a group presented as those of a single entity. (IFRS for SMEs Glossary of Terms)*

***Minority interest** is that portion of the net assets and profit or loss for a financial year of a subsidiary neither directly nor indirectly (through other subsidiaries) owned by the parent entity. (IFRS for SMEs Glossary of Terms).*

***Fair value** is the amount for which an asset could be exchanged or a liability settled in a transaction between knowledgeable, willing and independent parties in an arm's length transaction. (IFRS for SMEs 2.34 (b))*

***Operating activities** is a set of mutually connected activities, to be conducted, and (net)assets, which are managed with a purpose to generate:*

> **(a)** ***return to investors; or***
>
> **(b)** ***lower expenditures or other economic benefits. (IFRS for SMEs Glossary of Terms)***

6. For the definition of the terms "associate", "subsidiary", "parent entity" and "group", this guideline uses the approach of IFRS for SMEs and the Accounting Act that define the aforementioned terms through predominant or significant influence irrespective of

whether and how large the ownership interest in the share capital of the other entity is. Therefore, the meanings of the terms "subsidiary", "parent entity" and "group" in this guideline may in certain cases differ from the meaning of the terms "subsidiary", "parent entity" and "group" in the Commercial Code. Instead of the terms "subsidiary", "parent entity" and "group", the Accounting Act uses the terms "consolidated entity", "consolidating entity", and "consolidation group" in order to distinguish them from the terms "subsidiary", "parent entity" and "group" in the Commercial Code and also to apply them to non-profit accounting entities. In this guideline, the terms "subsidiary", "parent entity" and "group" have the same meaning as the terms "consolidated entity", "consolidating entity", and "consolidation group" of the Accounting Act.

7. In accordance with this guideline, subsidiaries are all entities under control of another entity (parent entity). Control is presumed to exist when the parent entity owns, directly or indirectly through its subsidiaries, more than half of the voting rights of the subsidiary unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent entity owns half or less of the voting rights of the subsidiary when the parent entity (IFRS for SMEs 9.5):

(a) power over more than half of the voting rights by virtue of an agreement with other investors;
(b) power to govern the financial and operating policies of the entity under a statute or an agreement;
(c) power to appoint or remove the majority of the members of the management and highest supervisory body (e.g. management board and supervisory board of the entity); or
(d) power to cast the majority of votes at meetings of the management and higher supervisory body.

8. Under this guideline, associates are all entities over which the investor has significant influence but not control. Under this guideline, associates are also these entities that are deemed joint ventures (entities under joint control of owners) by IFRS for SMEs. Significant influence is presumed to exist when the investor owns either directly or through its subsidiaries more than 20% of the voting rights of the associate, unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute significant influence. In exceptional circumstances, significant influence may exist if the share is less than 20%. (IFRS for SMEs 14.3) The existence of significant influence is usually characterised by the following factors:

(a) membership in the management or higher supervisory body of the investee;
(b) power to participate in the operating policy decisions of the investee;
(c) major transactions between the investor and the investee;
(d) partial overlapping of managements of the investor and the investee;
(e) exchange of technical information between the investor and the investee;

9. Options or convertible instruments that are currently exercisable, i.e. convertible into shares without further conditions shall also be included in the identification of the existence of control or significant influence. (IFRS for SMEs 9.6, 14.8 (b)).

Example 1 – Considering options in the identification of control

> Entity A owns a 40% interest in the shares of entity B. A also owns an option to acquire a further 20% of entity B's shares. The option is currently exercisable, i.e. no further conditions are attached to it. Voting rights at shareholder meetings are based on share ownership interest (i.e. A currently has 40% of votes and after exercising the option would have 60% of votes). A has the right to appoint one member to the three-member supervisory board (after exercising the option it can appoint two out of three members). Decisions at the shareholder meeting and supervisory board meeting are based on a simple majority of the votes.
>
> As A is able to achieve control by exercising its option and the option is exercisable without restrictions, A has control over entity B although its current share ownership interest is 40%. A must consolidate B line by line and allocate 60% to minority interest until the option is exercised.

10. Although most of the time subsidiaries and associates are accounting entities, in certain circumstances non-profit accounting entities (for example, foundations and non-profit institutions) may also meet the definition of a subsidiary or associate. In addition to the above-mentioned criteria, the determination of control or significant influence of non-profit accounting entities is also based on which accounting entity shall take possession of the assets of the non-profit entity upon its liquidation.

Accounting for Business Combinations in Consolidated Financial Statements

General Principles - Purchase Method and Adjusted Purchase Method

11. ***The purchase method of accounting is used to account for business combinations. (IFRS for SMEs 19.6) An exception is business combinations between entities under common control, which is accounted for using amortised purchase method.***

12. The concept of business combination shall be applied in accounting for subsidiaries in a group's consolidated financial statements. Although acquisition of significant influence in another entity (associate) does not meet the definition of the business combination, similar accounting policies as for business combination shall be applied to the acquisition of associates accounted for using the equity method. Shares of acquired subsidiaries and associates shall be accounted for in the parent entity's separate financial statements based on the description provided in clauses 60-64.

13. All business combinations involving independent parties shall be accounted for using the purchase method. The application of the purchase method is described in clauses 19-49.

14. If a business combination involves entities under the control of one and the same person or one and the same group of persons, the business combination may not take place under market conditions, as a result of which the application of the regular purchase method may not objectively reflect the substance of the transaction. Business combinations involving entities under common control shall be accounted for using the

adjusted purchase method. The application of the adjusted purchase method is described in clauses 50-55.

15. Business combinations may involve the acquisition of the shares of another entity or all assets and liabilities of another entity or a share of assets and liabilities of another entity under the assumption that these jointly form one or several businesses. (IFRS for SMEs 19.4, 19.5) The fact whether the shares or assets and liabilities of another entity are acquired in a business combination impacts neither the accounting policy nor the recognition principles of the business combination in the consolidated financial statements. In separate financial statements, the acquired shares are accounted for in accordance with clause 63, however if only assets are acquired and liabilities assumed, these shall be added line by line to the balance sheet of the acquirer.

16. As a result of a business combination, the entities participating in a business combination may legally form one entity but they may also continue to operate as separate legal entities (as a parent entity and a subsidiary). The fact whether the entities in a business combination merge legally or continue as a subsidiary and a parent entity impacts neither the accounting policy nor the recognition principles of the business combination in consolidated financial statements. In case of a legal merger, in the separate financial statements the assets and liabilities of the acquiree shall be included line by line in the balance sheet of the acquirer (also see clauses 56-57 on mergers); in case the entities continue as separate legal entities, the shares acquired shall be accounted for in accordance with clauses 60-64.

17. The merger of the parent entity with its wholly owned subsidiary does not constitute a business combination according to this guideline because the parent entity and its subsidiary were already one reporting entity before the merger. The effect of such mergers on the financial statements of the parent entity is dealt with in clauses 56-57 of this guideline.

18. An acquisition of minority interest, i.e. a transaction whereby minority interest is reduced in an entity already under control of the parent, is also not deemed a business combination. Accounting for transactions with minority interest is dealt with in clause 76 of this guideline.

Purchase Method

Application of the Purchase Method

19. ***Applying the purchase method involves the following steps (IFRS for SMEs 19.7, 19.17):***

(a) identifying an acquirer and acquisition date;

(b) measuring the cost of the business combination; and

(c) allocating, at the acquisition date, the cost of the business combination to the assets acquired and liabilities and provisions for contingent liabilities assumed (i.e. acquired net assets).

20 The following equation characterises the application of the purchase method:

Cost of the acquisition

- Fair value of acquired net assets

= Goodwill

21. The accounting for the cost of the acquired ownership interest is dealt with in clauses 26-33 of this guideline; the measurement of the acquired net assets and their fair value in clauses 34-43 and the accounting for goodwill in clauses 44-49.

22. Acquirer is deemed to be an entity who acquires control over the acquiree or the operating activity. (IFRS for SMEs 19.8).

23. The date of acquisition is the date at which substantive control over the acquiree or its operating activities is transferred to the acquirer. Because control is the power to influence the financial or operating policies of another entity or operating activities so as to obtain economic benefits from it, it is not necessary for a transaction to be finalised at law in order to obtain control. (IFRS for SMEs 19.3, 19.17).

24. Based on materiality, upon the application of the purchase method, the balance sheet as at the end of the month closest to the date of acquisition may be used as a basis if it does not materially differ from the one on the date of acquisition.

25. From the date of acquisition, the acquirer shall recognise its ownership interest in the assets, liabilities and contingent liabilities and the resulting goodwill of the acquiree in its consolidated balance sheet and its interest in income and expenses of the acquiree in its consolidated income statement. (IFRS for SMEs 19.15, 9.18).

Measurement of the Cost of Acquisition

26. ***The cost of acquisition of ownership interest is the fair value payable upon acquisition (i.e. of assets given, liability assumed, and equity instruments issued by the acquirer for the purpose of the acquisition) and any costs directly attributable to the acquisition. (IFRS for SMEs 19.11).***

27. If the payment for the acquisition is deferred, the present value of the consideration payable is considered to be the cost. (IFRS for SMEs 23.5).

28. If the acquisition is paid for with the shares issued for this purpose by the acquirer, the fair value of the issued shares is considered to be the cost. The best indicator of the fair value is the market price of shares. If the market price of shares cannot be determined reliably, then either of the following methods shall be used for measuring the cost, depending on which of them provides more reliable results:

(a) proportionate ownership interest in the shares issued upon acquisition at the fair value of the acquiree (e.g. assessed by using the discounted cash flow method); or

(b) proportionate ownership interest in the acquired shares at the fair value of the acquiree (e.g. assessed by using the discounted cash flow method).

29. If an acquirer had a previously held ownership interest in but not control over the acquired entity (i.e. the acquired entity was an associate or financial investment of the

acquirer), the fair value of the previously held ownership interest at the acquisition date shall also be deemed a part of the cost of acquisition. The difference between the carrying amount of the previously held ownership interest and the fair value at the acquisition date shall be recognised as a profit or loss in the income statement. (IFRS for SMEs 14.8 (i) (i))

30. Examples of expenditures directly relating to the acquisition are fees paid to the advisers (e.g., for due diligence of the acquiree), notary fees, state fees and other costs without which the transaction would probably have not occurred. The costs of assuming financial liabilities and issuing equity instruments for the purpose of financing the acquisition of ownership interest are not considered expenditures directly relating to the acquisition. Instead, such costs shall be included in the initial measurement of the liability and equity instruments in accordance with ASBG 3 "Financial Instruments".

31. ***When the consideration payable for the acquisition is contingent on certain additional conditions, the probable effect of such additional conditions on the purchase price shall be assessed at the date of acquisition and included in the cost of the acquisition, if the payment is probable and its amount can be measured reliably. (IFRS for SMEs 19.12) Subsequent adjustments to the purchase price shall be recorded as an adjustment to the cost of the acquisition of ownership interest. (IFRS for SMEs 19.13).***

32. Examples of additional conditions impacting the purchase price are the contingency of the consideration on the sales, profit, EBITDA or some other indicators of the acquiree during a certain time period after the acquisition.

33. Upon measuring the cost, a probable additional consideration arising from additional conditions shall be considered, except when it cannot be measured reliably. If the initial estimate made at the date of acquisition turns out to be inaccurate, the cost of the acquisition shall be adjusted upon obtaining additional information, which in turn influences the amount of goodwill resulting from the acquisition.

Acquired Net Assets and Measurement of their Fair Value

34. ***The fair value of the acquired net assets is the fair value of assets, liabilities and contingent liabilities of the acquiree that meet the criteria provided in clause 37, less the minority interest's share of the fair value of the net assets. (IFRS for SMEs 19.14).***

35. ***A purchase price allocation shall be prepared for allocating the cost to the fair value of the assets acquired, and liabilities and contingent liabilities assumed.***

36. A purchase price allocation is the accounting source document for accounting for a business combination. A purchase price allocation shall meet the requirements set for source documents in the Accounting Act and additionally shall contain the following information:

(a) name of the acquiree and date of acquisition;
(b) carrying amounts of the acquired assets and liabilities;
(c) fair value of the assets acquired, liabilities and contingent liabilities assumed and the basis for measurement;

(c) minority interest's share at the fair value of the assets acquired, liabilities and contingent liabilities assumed;
(e) fair value of the net assets acquired;
(f) cost of the acquired ownership interest;
(g) positive or negative goodwill generated.

37. ***The acquirer shall recognise separately the acquiree's assets, liabilities and contingent liabilities at acquisition date in the purchase price allocation (and on the basis thereof also in the consolidated financial statements), only if these exist at that date (regardless of whether or not recorded in the acquirer's balance sheet) and satisfy the following criteria (IFRS for SMEs 19.15, 19.18 (a)):***

(a) ***in the case of an asset other than an intangible asset, it is probable that any associated future economic benefits will flow to the acquirer and its fair value can be measured reliably;***
(b) ***in the case of an intangible asset, its fair value can be measured reliably (see also ASBG 5, clauses 33–49);***
(c) ***in the case of liabilities, it is probable that an outflow of resources will be required to settle the liability and its fair value can be measured reliably. The acquirer shall recognise a restructuring provision only when the acquiree at acquisition date has an existing obligation relating to the restructuring in accordance with ASBG 8 "Provisions, Contingent Assets and Contingent Liabilities";***
(d) ***contingent liabilities if the fair value can be measured reliably.***

Example 2 – Intangible assets to be recognised separately in the purchase price allocation

Examples of intangible assets, the fair value of which can be measured reliably and which shall be recognised separately in the purchase price allocation:
• trademarks that are legally protected (registered);
• registered internet domain names;
• packages of goods (unique colour, shape, design), newspaper headings;
• customer lists except if the confidentiality or other agreements prohibit the entity from selling, leasing or otherwise exchanging this information;
• customer contracts;• artistic-related intangible assets protected by copyright (plays, books, newspapers, operas, pictures, etc.);
• patented and unpatented technology;
• computer software (legally protected);
• databases (either legally protected or with the possibility to sell, lease or otherwise exchange these databases):
• trade secrets (formulas, recipes, etc.)

38. The following general rules shall be used as the basis for measuring the fair value of the acquiree's assets, liabilities and contingent liabilities:

(a) securities – at market value; if market value is not known, at fair value measured on the basis of another valuation model (e.g. by using the discounted cash flow method);
(b) receivables – in the present value of the cash inflow receivable (short-term receivables do not need to be discounted; long-term receivables are discounted at the market rate);
(c) inventories:

i) goods and finished goods – in sales price, less costs to sell and normal profit margin of the acquirer in selling similar goods;
ii) goods and unfinished goods – in the sales price of finished goods, less costs necessary for the manufacture of the product, costs to sell and normal profit margin of the acquirer in selling similar goods;
iii) raw materials – at replacement cost;

(d) land and buildings - at market value;
(e) other fixed assets - at market value; if market value cannot be reliably determined, at amortised replacement cost;
(f) intangible assets - at market value, if active market exists; if there is no active market, in an amount, which the parties would be willing to pay in an arm's length transaction;
(g) liabilities, incl. onerous contracts (see the definition in clause 28 of ASBG 8) - in the present value of the amount payable (short-term liabilities do not need to be discounted; long-term liabilities are discounted at the market rate);
(h) contingent liabilities - in the amount, which a third party would be willing to pay for the assumption of the contingent liability. This amount shall take into consideration all expectations regarding estimated cash flows resulting from a contingent liability, not only the most probable amount or maximum or minimum expected cash flows. After their initial recognition, the acquirer shall measure the contingent liability at the higher of (IFRS for SMEs 19.21):

i) in amount, in which the liability would have been accounted for in accordance with ASBG 8;
ii) in an amount, in which the contingent liability was initially recognised, less cumulative amortisation arising from discounting, if necessary.

39. Although the "old" carrying amounts of assets acquired and liabilities assumed have theoretically no value for determining the fair value of the acquired net assets, in practice they often form a basis for preparing the purchase price allocation as the carrying amounts of assets and liabilities can approximate their fair values. Therefore, the carrying amounts of assets and liabilities of the acquiree prior to the business combination are often be used as the basis for the preparation of the purchase price allocation and shall be adjusted for any differences as compared to their fair values. An example of the preparation of the purchase price allocation is provided in Note 1 of this guideline.

40 If shares and not net assets are acquired in a business combination and the acquired subsidiary shall continue as a separate legal entity, adjustments made in the purchase price allocation shall not be included in the financial statements of the acquired subsidiary. In the consolidated financial statements of the acquirer, the assets acquired and liabilities assumed shall be recognised at their "new" fair value as determined by the purchase price allocation. The effect of adjustments made during the purchase price allocation on the consolidated financial statements is described in Note 1 to this guideline.

41. Minority interest in an acquiree is the minority shareholders' share of the fair value of the acquiree's net assets. The proportion of equity allocated to the minority interest is determined on the basis of the acquirer's existing ownership interests in the acquiree and does not reflect the possible effect of options or convertible instruments. (IFRS for

SMEs 9.14) The effect of such instruments is considered only to determine whether the acquirer has control (see clause 9 of this guideline). An example of the calculation of the proportion belonging to the minority interest in the purchase price allocation and its subsequent measurement in the consolidated statements is provided in Note 1 to this guideline.

42. Upon accounting for business combinations, situations may arise when the fair value of the assets, liabilities and contingent liabilities of the acquiree or the cost of the acquisition of ownership interest can only be determined provisionally because no reliable information exists for their exact measurement at the time that financial statements are prepared. In such a case, the acquirer shall use initial provisional values for the initial recognition of a business combination. Adjustments to these values may be made within 12 months after the date of acquisition, by recording them retrospectively as if they had already been made at the date of acquisition (e.g., upon adjusting the fair value of property, plant and equipment, depreciation shall also be calculated based on the new fair value during the period between the date of acquisition and the adjustment date of the fair value). Also, goodwill or negative goodwill recognised as income as well as the comparative information of the previous period shall be adjusted. (IFRS for SMEs 19.19).

43. After completing the initial recognition described in clause 42, the purchase price allocation shall only be adjusted in order to correct errors in accordance with ASBG 1 "General Principles for Preparation of Financial Statements" (except for adjustments arising from the additional conditions described in clause 31). (IFRS for SMEs 19.19) The effect of changes in estimates shall not be recognised as an adjustment of the purchase price allocation but as an income or expense for the period when the estimate is made or for future periods in accordance with ASBG 1.

Accounting for Goodwill

44. ***Goodwill is the positive difference between the cost of acquisition and the fair value of the acquired net assets. At the date of acquisition, the acquirer shall recognise goodwill at its cost as an intangible asset on its consolidated balance sheet. (IFRS for SMEs 19.22).***

45. Goodwill arising in a business combination represents the portion of the acquisition cost paid by the acquirer for such assets of the acquiree that cannot be separated and separately accounted for.

46. The subsequent accounting for goodwill is based on the principles described in clauses 44-49 of the guideline ASBG 5 "Property, Plant and Equipment and Intangible Assets".

Accounting for Negative Goodwill

47. ***Negative goodwill is the negative difference between the cost of acquisition of ownership interest and the fair value of the acquired net assets.***

48. Negative goodwill arises in situations when the cost of acquisition is lower than the fair value of the acquired net assets. Such situations arise relatively infrequently in transactions between independent parties. Therefore, before recognising negative

goodwill in the balance sheet of the acquirer it should be ascertained that negative goodwill has not arisen as a result of either of the following reasons:

(a) a business combination involved entities under common control as a result which the purchase price does not reflect the actual value of the acquiree. In such a case, the adjusted purchase method shall be implemented instead of the regular purchase method (see clauses 50-55);

(b) an error was made in the purchase price allocation when measuring the fair value of the assets acquired, liabilities and contingent liabilities assumed, or the cost of acquisition of a business combination was set incorrectly. In such a case, the purchase price allocation shall be adjusted first. (IFRS for SMEs 19.24 (a)).

49. ***If negative goodwill arises in a business combination, the acquirer shall immediately recognise as income in the consolidated income statement the whole negative goodwill that remains after the adjustments described in clause 48. (IFRS for SMEs 19.24 (b)).***

Business combinations of entities under common control – adjusted purchase method

50. ***Upon the application of the adjusted purchase method, the assets and liabilities of the acquiree or business shall be recognised on the acquirer's balance sheet at the carrying amount (i.e. as the assets acquired and liabilities assumed had been recorded on the balance sheet of the acquiree). The difference between the cost of acquisition and the carrying amount of the acquired net assets shall be recognised as an increase or decrease of the equity of the acquirer.***

51. The following equation characterises the application of the adjusted purchase method:

  Cost of the acquisition
\- Carrying amount of acquired net assets

= Increase or decrease of equity

52. The adjusted purchase method shall be applied to recognising business combinations involving entities under common control in consolidated financial statements. For such business combinations, the combination might not occur under market conditions, as a result of which the application of the regular purchase method may distort the presentation of the occurred transaction. For example, the acquisition price in the transaction involving entities under common control may not reflect the actual value of the acquiree. As a result, neither positive nor negative goodwill has their usual meaning.

53. The adjusted purchase method is based on the assumption that the difference between the cost of acquisition of ownership interest and the carrying amount of the acquired net assets in the case of business combinations involving companies under common control is, in substance, an additional contribution made by a controlling owner into the equity of the acquirer (if the cost is lower) or a distribution from the equity of the acquirer (if the cost is higher).

54. The application of the adjusted purchase method is similar to the regular purchase method, except for the following factors:

(a) no assets, liabilities or contingent liabilities of the acquiree are restated at fair value in the purchase price allocation; instead, these are recognised on the balance sheet of the acquirer at their carrying amounts;

(b) the difference between the cost of acquisition of the ownership interest and the carrying amount of the acquired net assets shall not be recognised as positive or negative goodwill, but instead, it is recorded as an increase or decrease of the equity of the acquirer (either in the item “share premium" or in any other justified equity item).

55. An example of accounting for business combinations involving entities under common control are provided in Note 2 to this guideline.

Mergers and Demergers

56. The legal merger of the parent entity with its wholly owned subsidiary does not constitute a business combination according to this guideline because the parent entity and its subsidiary were already one reporting entity before the merger.

57. The legal merger of the parent entity with its wholly owned subsidiary shall not have an effect on the consolidated financial statements of the parent entity. From the time of the legal merger, the parent entity shall derecognise the shares of its subsidiary in its separate financial statements in accordance with clause 63 and shall recognise the assets and liabilities of the subsidiary and income and expenses on a line-by-line basis using the same carrying amounts as those recognised in the consolidated financial statements. If the legally acquiring company is a subsidiary, the acquiring company shall begin to recognise the assets and liabilities, income and expenses on a line-by-line basis using the same carrying amounts as those recognised in the parent company's consolidated financial statements.

58. The legal merger of other entities of the same group (e.g. two fellow subsidiaries) shall be accounted for as a business combination of entities under common control, using the adjusted purchase method. Possible difference between the carrying amount of the net assets of the merged entities and the nominal value of share capital issued during the merger is recorded in a proper item in the share capital of the new merged entity.

59. In case of demerger, the companies participating in the demerger shall account for assets and liabilities obtained or transferred upon demerger in their pre-demerger carrying amounts. Possible difference between the carrying amount of the net assets of the companies participating in the demerger and the changes in the nominal value of the share capital of the demerged entities shall be recognised in the appropriate item in the equity of the companies participating in the demerger. In exceptional cases, if the company receiving the assets and liabilities in the demerger is a business combination between independent parties, the principles of the purchase method shall be applied in the accounting of that company.

ACCOUNTING FOR SUBSIDIARIES AND ASSOCIATES

Accounting Policies for Consolidated and Separate Financial Statements

60. ***Subsidiaries are consolidated line-by-line in the consolidated financial statements (see also clauses 65-85 of this guideline). (IFRS for SMEs 9.13 (a)).***

61. In accordance with the materiality principle, the cost, fair value or equity method for the accounting for immaterial subsidiaries is allowed to be used instead of the line-by-line consolidation in the preparation of consolidated financial statements.

62. ***In consolidated financial statements and the financial statements of their investors not preparing consolidated financial statements due to absence of subsidiaries, associates shall be accounted for either (IFRS for SMEs IFRS 14.4):***

(a) using the cost method (see clauses 86-88);
(b) using the equity method (see clauses 89-99); or
(c) at fair value (see clauses 100-101).

63. ***Subsidiaries and associates shall be accounted for in the parent entity's separate financial statements either:***

(a) using the cost method (see clauses 86-88);
(b) using the equity method (see clauses 89-99); or
(c) at fair value (see clauses 100-101).

64. The choice between accounting policies provided in clauses 60-63 shall be made so as to ensure that all investments of the same category are accounted for using the same accounting policy (i.e. for example all subsidiaries are accounted for in the same way). An investment entity, applying the exemption provided for in the Accounting Act in regard of line-by-line consolidation of the unit in connection with holding the shares of the consolidated entity exclusively with a view to their subsequent resale, records its subsidiary at fair value (IFRS for SMEs 9.26).

CONSOLIDATION

Preparation of Consolidated Financial Statements

65. ***Consolidated financial statements present financial information about the parent entity and its subsidiaries combined as a single entity. (IFRS for SMEs 9.13).***

66. Consolidated financial statements shall be prepared if so required by the Accounting Act. The parent entity may prepare and publish consolidated financial statements even if not required by law. Consolidated financial statements are in compliance with the Estonian financial reporting standard only if the accounting policies, presentation and disclosures meet the requirements of the Accounting Act and the guidelines of the Board.

67. Consolidated financial statements consist of the consolidated balance sheet, income statement, cash flow statement, statement of changes in equity and the respective notes that among other things include the separate balance sheet, income statement, cash flow statement, and statement of changes in equity of the parent entity.

68. In preparing the consolidated financial statements the same principles shall be applied as in preparing the separate financial statements except for the fact that all information regarding the parent entity and its subsidiaries shall be presented as that of a single entity. Notes to consolidated financial statements must contain similar information as notes to separate financial statements. That means that they must comply with the requirements of all guidelines of the Board with regard to disclosure of information in the notes.

69. In the consolidated financial statements all subsidiaries under the control of the group shall be consolidated line-by-line (including subsidiaries of subsidiaries etc.), (line-by-line consolidation does not have to be applied to subsidiaries mentioned in clause 61). Entities shall also be consolidated if the group has control over them, in substance, regardless of whether or not the group has an ownership interest in them. (IFRS for SMEs 9.11).

General Principles for Consolidation

70. ***The main accounting procedures of consolidation are (IFRS for SMEs 9.13):***

(a) ***the financial figures (items of the balance sheet, income statement, and cash flow statement and by adding and changing the financial figures to be disclosed in other parts of the statement) of the parent entity and its subsidiaries are combined on a line-by-line basis (income and expenses and cash flows of the subsidiary generated before the date of acquisition are not included in the consolidated income statement and cash flow statement);***

(b) ***the carrying amount of the parent's investment in subsidiaries and the parent's portion of equity of each subsidiary are eliminated;***

(c) ***if the ownership interest of parent entity is less than 100% for some subsidiaries, the share of minority interest shall be separated from the net assets and profit or loss for the accounting period of such subsidiaries;***

(d) ***intragroup receivables and liabilities, intragroup transactions and unrealised profits and losses resulting from these, are eliminated in full (IFRS for SMEs 9.15);***

(e) ***if the shares of parent entity are recorded on the balance sheet of subsidiaries as a financial investment, these shall be reclassified into treasury shares in the consolidated balance sheet.***

71. The financial statements of all subsidiaries being consolidated shall be prepared using uniform accounting policies. If a consolidated subsidiary has prepared its financial statements using some other policies (for example, in accordance with generally accepted accounting principles of a foreign country), appropriate adjustments shall be made to the financial statements of the subsidiary before the consolidation to bring them in compliance with the accounting policies of the group. (IFRS for SMEs 9.17).

72. The starting point for consolidation shall be the fair value of acquired assets and assumed liabilities and contingent liabilities determined in purchase price allocation (except in case the business combination occurred under common control). Therefore, the values of assets, liabilities, revenues and expenses included on the subsidiary's balance sheet must be adjusted upon consolidation, if necessary, in order to take into account the difference between the fair value of assets, liabilities and contingent

liabilities identified in purchase price allocation and the carrying amount of assets and liabilities included on the subsidiary's balance sheet at the date of acquisition. Goodwill arising from the business combination must also be recorded upon consolidation, as well as the assets and liabilities identified in the purchase price allocation that were not carried on the acquiree's balance sheet (see clause 37).

73. Subsidiaries shall be consolidated from the date of their acquisition until the date of their disposal. When a subsidiary is disposed of during the accounting period, the income and expenses of the disposed subsidiary shall be included in the consolidated income statement until the date of disposal. The difference between the proceeds from the disposal and the carrying amount of the subsidiary's net assets in the group's balance sheet (including goodwill) as of the date of disposal shall be recognised as a profit (or loss) from the disposal of the subsidiary. (IFRS for SMEs 9.18).

74. ***Minority interest shall be included as share of equity in the consolidated balance sheet, separately from the equity of parent entity's equity (see also the balance sheet format presented in Note 1 to ASBG 2) and in a separate line of the consolidated income statement (see also the income statement format presented in Note 2 of ASBG 2). (IFRS for SMEs 9.20, 9.21).***

75. Minority interest's share of the loss of the consolidated subsidiary shall be attributed to the minority interest even if this results in the minority interest having a deficit balance on the balance sheet. (IFRS for SMEs 9.22).

76. Transactions increasing or decreasing an entity's ownership interest in a subsidiary under its control (transactions with minority interest) shall be recorded as transactions between owners without any resulting goodwill or profit or loss created. Any difference between the purchase or sales price and the changed carrying amount of minority interest shall be recognised directly in equity (similarly to the differences arising in purchase and sale of treasury shares). (IFRS for SMEs 22.19) An example of the transactions with minority interest is provided in Note 4 to this guideline.

Consolidation of foreign entities

77. ***For the consolidation of foreign subsidiaries and other businesses, their financial statements shall be translated from their functional currency into the parent's presentation currency. (IFRS for SMEs 30.17).***

78. In preparing the financial statements, the functional currency of each subsidiary shall be determined. If the subsidiary's functional currency does not match the parent's presentation currency, this subsidiary's financial information shall be translated based on clauses 80-85.

79. The definitions of functional and presentation currency are presented in clauses 86-92 of ASBG 1 "General Principles for Preparing the Financial Statements". The functional currency of a foreign subsidiary is normally the functional currency of the country in which the entity is located, but it can also be another currency (incl. the presentation currency of the parent entity). If the criteria provided in ASBG 1 do not provide a clear answer for determining the foreign subsidiary's functional currency, the following additional factors shall be considered to determine whether or not the

functional currency of this subsidiary coincides with the functional currency of the parent entity. The functional currency of a foreign subsidiary does not probably coincide with the functional currency of the parent if (IFRS for SMEs 30.5):

(a) the management of the subsidiary has a significant degree of autonomy in everyday business decisions;

(b) there is a relatively low proportion of transactions with parent entity;

(c) subsidiary's operations are financed rather with local loans than by parent entity or other group entities;

(d) majority of the expenditures of the subsidiary (e.g. wages of employees, raw material) are denominated in local currency;

(e) majority of the earnings of the subsidiary are not denominated in parent entity's currency;

(f) the activity of the subsidiary has no direct effect on parent entity's cash flows.

80. ***If the functional currency of a subsidiary is not the same as the presentation currency of the parent entity, the following exchange rates shall be used for translating the financial statements of the subsidiary, prepared in a foreign currency (IFRS for SMEs 30.18, 30.19):***

(a) all assets and liabilities shall be translated based on the exchange rate as at the reporting date;

(b) income, expenses and other changes in equity hall be translated at the spot exchange rate at the date when they occur (for practical reasons, the weighted average rate for the period may also be used).

81. For example, such translation described in clause 80 shall be used in a situation when the parent entity located in Estonia and whose presentation currency is the euro, has a subsidiary in Sweden, whose functional currency is the Swedish krona and that presents its financial statements for consolidation in Swedish krona.

82. As different exchange rates are used for the translation of different components, then in the translation process a translation difference arises, which shall be recognised in the statement of comprehensive income item "Unrealised exchange rate differences". (IFRS for SMEs 30.18 (c)) If the parent entity's ownership interest in the subsidiary is less than 100%, the share belonging to the minority shareholders shall also be separated from unrealised exchange differences.

83. If the parent entity has granted a long-term loan to its subsidiary described in clause 80 (or received a long-term loan from such a subsidiary), whose repayment is not likely to occur in the foreseeable future, such a loan is, in substance, part of the parent's net investment in its subsidiary. Exchange differences arising on the revaluation of such loans shall be recognised in the statement of comprehensive income item "Unrealised exchange rate differences" (and not as a gain/loss from the exchange rate in the income statement) similarly to the differences arising from revaluation of the net assets. (IFRS for SMEs 30.12, 30.13) The exchange rate differences arising from translation of other intra-group balances shall be recognised in the income statement. (IFRS for SMEs 30.22).

84. Amounts that are recognised in the statement of comprehensive income and accumulated on the "Unrealised exchange rate differences reserve" line based on the

method described in clauses 82 and 83 shall not be reclassified into the income statement upon sale of the subsidiary described in clause 80 (IFRS for SMEs 30.13) but they may be reclassified into retained earnings.

85. ***Goodwill arising on the acquisition of a subsidiary described in clause 80 as well as the fair value adjustments to the carrying amounts of assets and liabilities relating to the acquisition of such a subsidiary shall be treated as the assets and liabilities of the subsidiary and shall therefore be translated on the basis of the exchange rate prevailing on the reporting date in accordance with clause 80. (IFRS for SMEs 30.23).***

Cost Method

86. ***Upon applying the cost method, an investment is initially recognised at cost, which is:***

> ***(a) cost in case of a transaction between independent parties, based on the principles provided in clauses 26-33;***
> ***(b) in case of a transaction between entities under common control, either:***
>> ***(i) cost based on the policies provided in clauses 26-33; or***
>> ***(ii) the carrying amount of acquired net assets based on the policy provided in clause 50 regarding the adjusted purchase method.***

The choice permitted in clause (b) shall be applied equally to all transactions occurring under common control.

87. Cost shall later be adjusted by any impairment losses arising from an impaired investment. At each reporting date, an assessment must be made on whether there are any indications that the recoverable value of an investment has declined to a level below its carrying amount. If there are any such indications, an impairment test shall be performed. Upon determining the recoverable amount of the investment, the impairment test described in ASBG 5 "*Property, Plant and Equipment and Intangible Assets*" shall be used as the basis. (IFRS for SMEs 9.26, 14.5).

88. When applying the cost method, the investor shall recognise dividends received from subsidiaries and associates as income in the parent's financial statements at the moment it receives the right to these dividends, without regard to whether the distributed earnings were earned before or after the date that the parent acquired the subsidiary or associate. (IFRS for SMEs 14.6).

EQUITY METHOD

89. ***Under the equity method of accounting, an investment is initially recognised at cost (pursuant to clause 86), and is subsequently adjusted in the following periods:***

> **(a)** ***with the investor's ownership interest in the changes in the equity of the investee;***
> **(b)** ***with the depreciation of goodwill created upon acquisition and possible impairment; and***
> **(c)** ***by accounting for the negative goodwill revenue created upon acquisition as described in clause 49. (IFRS for SMEs 14.8).***

90. Under the equity method, the share in the assets and liabilities of the acquiree and the resulting goodwill shall be recognised as a net amount on one balance sheet line and the share in the income and expenses of the acquiree as a net amount on one income statement line. Although acquisition of significant influence in another entity (associate) does not meet the definition of business combination, similar accounting policies as for business combination shall be applied to the acquisition of associates. To determine goodwill, purchase price allocation must be prepared based on clauses 26-49 (except if cost accounting is being performed based on clause 86 (b) (ii)). Goodwill arisen from the acquisition of an associate shall be recognised as part of the carrying amount of the associate. Negative goodwill arisen from the acquisition of an associate shall immediately be recognised as income in the income statement. (IFRS for SMEs 14.8 (c))

91. Under the equity method, all changes in the investee's equity shall be recognised in the balance sheet of the investor – both those that are included in the profit or loss of the investee as well as those that are included as changes in other equity items of the investee.

92. The profit or loss under the equity method includes the following elements (IFRS for SMEs 14.8):

(a) investor's share of the profit or loss of the investee (generated after the date of acquisition);

(b) depreciation of goodwill, created upon acquisition (subsequent accounting for goodwill is based on the principles described in clauses 44-49 of ASBG 5 "*Property, Plant and Equipment and Intangible Assets*");

(c) if the fair value of the acquired assets, assumed liabilities and contingent liabilities in the purchase price allocation differs from their carrying amount, elimination of the differences (e.g. in regard of the assets revalued in the purchase price allocation and sold by the reporting date) or depreciation (e.g. for differences, between the carrying amount and fair value of the fixed assets subject to depreciation);

(d) elimination of the unrealised profit or loss incurred from mutual transactions between the investor and the investee;

(e) possible write-down due to impairment of the investment (a test for impairment must be carried out if there are indications that an investment may be impaired; the test for impairment shall be performed based on the principles described in ASBG 5 "*Property, Plant and Equipment and Intangible Assets*").

93. Unrealised profits or losses arising from the transactions between the investor and investee shall be eliminated to the extent of the investor's share in the associate (unless the reason for the loss is the impairment of assets – in such a case the loss shall not be eliminated). (IFRS for SMEs 14.8 (e))

94. Examples of changes in the investee's equity accounted for using the equity method that do not affect the profit or loss accounted for using the equity method, are:

(a) payment of dividends by the investee (IFRS for SMEs 14.8 (a)); and

(b) increasing or decreasing the share capital of the investee provided that the investor's share does not change.

95. Reclassifications from one equity item of the investee to another (e.g., setting up the legal reserve in the balance sheet of the investee) do not affect the equity of the investee, therefore, such a transaction shall not be recognised in the financial statements of the investor. The ratio of unrestricted to restricted equity in the balance sheets of subsidiaries and associates shall not impact the ratio of unrestricted and restricted equity in the balance sheet of the parent entity.

96. Such unrealised income and expenses relating to the investee that in accordance with IFRS for SMEs and the guidelines of the Board are recognised in the statement of comprehensive income or as an increase or decrease of the equity reserves rather than the income statement, shall be recognised under the equity method also in the statement of comprehensive income or as a change in the equity reserves in the financial statements of the investor and not as a profit (loss) under the equity method. Examples of unrealised income and expenses recognised in the statement of comprehensive income are the differences arising on foreign currency translations of foreign subsidiaries and associates.

97. If the accounting policies applied in the financial statements of the investee differ from the accounting policies applied in the financial statements of the investor, adjustments shall be made before the application of the equity method in the financial statements of the investee, to bring them in conformity with the accounting policies of the investor. (IFRS for SMEs 14.8 (g))

98. If an investor's share of the losses of the investee recognised using the equity method exceeds the carrying amount of the investee, the carrying amount of the investment is reduced to zero and additional losses are recorded off-balance sheet. An exception is a situation when the investor has guaranteed or is required to satisfy the liabilities of the investee and as at the reporting date it becomes apparent that the investee cannot fulfil its obligations – in such a case the investor shall recognise both its liability in its balance sheet and the loss under the equity method. (IFRS for SMEs 14.8 (h))

99. Loans granted to the investee by the investor and other receivables from the investee except for such long-term receivables that, in substance, form part of the investment in the investee, shall be assessed according to their collectibility (based on the rules for impairment of financial assets set out in ASBG 3 "*Financial Instruments*"). The negative equity of the investee may but need not indicate the need for a write-down of receivables from the investee. Long-term receivables that, in substance, form part of the investment in the investee are such receivables whose settlement is neither planned not likely to occur in the foreseeable future. Such receivables may include preference shares or long-term receivables or loans but shall not include trade receivables, trade payables or such long-term receivables for which adequate collateral exists. Losses recognised under the equity method in excess of the investor's investment in equity shall be recognised as a write-down of such long-term receivables that, in substance, form part of the investment in the investee. An example of the application of the equity method is provided in Note 3 to this guideline.

Fair Value Method

100. ***Under the fair value model, an investment shall initially be recognised at cost (based on policies provided in clauses 26-33, except transaction costs that are recorded immediately in the income statement) and is subsequently carried at fair value through profit or loss (based on ASBG 3 "Financial Instruments"). (IFRS for SMEs 14.9).***

101. ***When using the fair value model, all investees of the same category shall be measured at fair value, except the ones whose fair value cannot be measured reliably without undue cost or effort. Such investees shall be measured at cost based on clauses 86-88. (IFRS for SMEs 14.10).***

DISPOSAL OF SUBSIDIARIES AND ASSOCIATES

102. Upon disposal of a subsidiary or associate, the difference between the carrying amount of the subsidiary or associate (in consolidated financial statements, a subsidiary's carrying amount includes all of the assets, liabilities and related goodwill of the subsidiary to be sold) and the consideration receivable shall be recognised as a profit or loss in the income statement.

103. If a subsidiary or associate is partially disposed of, resulting in a loss of control over a subsidiary or loss of significant influence over an associate, while maintaining ownership interest (i.e. ownership interest in a subsidiary is reduced so that it becomes a financial investment or associate, or ownership interest in an associate is reduced so that it becomes a financial investment), the retained ownership interest shall be recognised at fair value if it can be measured without undue cost or effort (otherwise the carrying amount of the retained investment shall become the new cost). The difference between the fair value of the retained ownership interest and its carrying amount shall be recognised as a profit or loss in the income statement. (IFRS for SMEs 9.19, 14.8(i)(ii))

COMPARISON WITH IFRS FOR SMES

104. The policies prescribed in ASBG 11 for accounting for business combinations involving independent parties using the purchase method are generally in compliance with the policies prescribed in section 19 of IFRS for SMEs.

105. Unlike ASBG 11, neither IFRS for SMEs nor other international financial reporting standards regulate the accounting for business combinations involving entities under control. For developing the adjusted purchase method described in this guideline, international practice in accounting for business combinations involving entities under control has been taken into consideration.

106. The policies set out in ASBG 11 for the application of the equity method are in compliance with the policies set out in section14 of IFRS for SMEs.

107. The policies set out in ASBG 11 for the consolidation of subsidiaries are in compliance with the policies set out in section 9 of IFRS for SMEs.

108. There are no separate provisions in ASBG 11 for the accounting of joint ventures as these are treated as associates. Although IFRS for SMEs differentiates joint ventures from associates, there are no substantive differences in the accounting for them. Accordingly, it is not deemed necessary to regulate separately the recording of joint ventures.

109. Based on clause 103, in situations where an investor loses control or significant influence over an investee but maintains ownership interest, the retained ownership interest shall be accounted for at fair value (or at carrying amount if fair value cannot be determined without undue cost or effort). Sections 9 and 14 of IFRS for SMEs provide different approaches to loss of control (cost of the retained ownership interest is its carrying amount) and loss of significant influence (retained ownership interest shall be accounted for at fair value). Based on the conditions of Estonia and business practice, establishment of a common method of accounting should be considered reasonable.

110. ASBG 11 allows an investment entity to account for subsidiaries at fair value instead of line-by-line consolidation. There is no such exception in IFRS for SMEs, still it is stipulated in IFRS 10. Introducing an exception to ASBG 11 is due to the nature of business of an investment entity. The business objective of an investment entity is to invest only for achieving value increase of capital and investment income (such as dividends, interest, rental income) or both. When determining whether or not an accounting entity is an investment entity, the principle described in IFRS 10 must be taken as guidance.

NOTE 1 – APPLICATION OF THE PURCHASE METHOD AND ACCOUNTING FOR SUBSIDIARIES AND ASSOCIATES

Example 1.1 – accounting for a subsidiary in the consolidated and separate financial statements

At 30.06.20X1, entity A acquired 80% of the shares in subsidiary B for the price of 200,000 euros. As at 30.06.20X1, the carrying amount of the subsidiary's equity was 160,000 euros. The carrying amounts of the assets and liabilities of the subsidiaries at the date of acquisition were approximately the same as their fair values, except for fixed assets whose fair value was 20,000 euros higher (the remaining useful life of these fixed assets whose fair value differs from the carrying amount was 10 years at the time of acquisition) and inventories whose fair value was 10,000 euros lower.

Balance sheet of subsidiary B	**30.6.20X1**
Assets	
Cash	10,000
Receivables	20,000
Inventories	120,000
Non-current assets	300,000
Total	**450,000**
Liabilities	
Suppliers	190,000
Loans	100,000
Total	**290,000**
Equity	
Share capital	100,000
Retained earnings	40,000
Net profit for financial year	20,000
Total	**160,000**
Total	**450,000**

The net profit of the subsidiary is 80,000 euros in 20X1, 20,000 of which was earned before 30.06.20X1 and 60,000 after 30.06.20X1. All inventories on the balance sheet at 30.06.20X1 had been sold by the end of the year. At 31.12.20X1, the parent entity sold inventories to its subsidiary for 100,000 euros, the carrying value of which was 50,000 euros in the parent entity's balance sheet. The parent entity had also granted a loan to its subsidiary, whose balance as at 31.12.20X1 was 100,000 euros. There were no other transactions between the parent entity and its subsidiary in 20X1. According to the management, the fair value of the subsidiary at 31.12.20X1 is 300,000 euros (80% of this is 240,000 euros).

(a) How to account for the business combination occurring at 30.06.20X1 (incl. preparation of purchase price allocation)?

(b) How does entity A's consolidated balance sheet at 31.12.20X1 look like (based on the balance sheets of both entities provided in the example)?

(c) How to account for the investment in the subsidiary in the separate balance sheet of the parent entity as at 30.06.20X1 and 31.12.20X1?

(a) Purchase price allocation as at 30.06.20X1:

Acquired net assets	**Carrying amounts**	**Adjustments**	**Fair values**
Assets			
Cash	10,000	–	10,000
Receivables	20,000	–	20,000
Inventories	120,000	-10,000	110,000
Non-current assets	300,000	+20,000	320,000
Total	**450,000**	**+10,000**	**460,000**
Liabilities			
Suppliers	190,000	–	190,000
Loans	100,000	–	100,000
Total	**290,000**	**–**	**290,000**
Net assets	**160,000**	**+10,000**	**170,000**
Minority interest (20%)			34,000
Parent's share in acquired net assets			**136,000**
Cost			**200,000**
Goodwill			**64,000**

The difference between the cost (200 000) and the fair value of the acquired net assets (136 000) shall be recognised as goodwill (64 000). Management estimated the useful life of goodwill to be eight years, thus it must be amortised over eight years.

(b) Consolidation

The balance sheets of entities A and B at 31.12.20X1 are as follows (the investment in the subsidiary is measured at cost on the parent's balance sheet):

	Parent A	**Subsidiary B**
Assets		
Cash	150,000	70,000
Receivables	80,000	50,000
Inventories	50,000	200,000
Loans granted	100,000	–
Investment in subsidiary	200,000	–
Goodwill	–	–
Non-current assets	320,000	280,000
Total	**900,000**	**600,000**

Liabilities		
Suppliers	260,000	180,000
Loans	40,000	200,000
Total	**300,000**	**380,000**
Equity		
Minority interest	–	–
Share capital	400,000	100,000
Retained earnings	100,000	40,000
Net profit for financial year	100,000	80,000
Total	**600,000**	**220,000**
Total	**900,000**	**600,000**

Upon consolidationthe investment in subsidiary recognised in parent entity's balance sheet ishall be eliminatedda against subsidiary's equity. As the subsidiary's equity (220 000) differs from the carrying amount of the investment on the parent's balance sheet (200 000), it is important to know the reasons for this difference for accurate elimination. In this example, the reasons for the difference are as follows:

Investee's equity	**220,000**
The differences between the carrying amount and the fair value of the net assets of the subsidiary at the time of acquisition:	
– non-current assets	+20,000
– inventories	-10,000
Minority interest at acquisition date	-34,000
Minority interest's portion of the profit generated after the acquisition (20% of 60 000)	-12,000
The parent's share of the profit generated after the acquisition (80% of 60 000)	-48,000
Goodwill	+64,000
Investment in the balance sheet of the parent entity	**200,000**

Knowing the reasons for the differences, a respective elimination entry can be prepared:

D	Subsidiary's equity (sum of equity items)	220,000
D	Goodwill	64,000
D	Non-current assets	20,000
Cr	Inventories	10,000
Cr	Minority interest (34 000+12 000)	46,000
Cr	Net profit for financial year	48,000
Cr	Investment in the subsidiary's shares	200,000

Upon preparing the consolidated financial statements, it should be reviewed whether and in which amount the differences between the carrying amounts and fair values of the net assets that arose on the basis of purchase price allocation will be eliminated or depreciated. In this example, the inventories written down have been sold as at 31.12.20X1, therefore the respective write-down shall be eliminated:

D	Inventories	10,000
Cr	Net profit for financial year (cost of goods sold)	10,000
D	Net profit for financial year (minority interest's share of the profit)	2,000
Cr	Minority interest (on the balance sheet)	2,000

Also, the difference between the fair value and the carrying amount of non-current assets in the amount of 20,000 euros shall be depreciated over the remaining life of non-current assets (i.e. in this example over ten years, of which half a year remains in 20X1):

D	Net profit for financial year (depreciation expense)	1,000
Cr	Non-current assets	1,000
D	Minority interest (on the balance sheet)	200
Cr	Net profit for financial year (minority interest's share of the profit)	200

Also, goodwill of 64,000 euros shall be amortised over its useful life (i.e. in this example over eight years, of which half a year remains in 20X1):

D	Net profit for financial year (depreciation expense)	4,000
Cr	Goodwill	4,000

In addition to the above, it is necessary to eliminate mutual receivables and liabilities and unrealised profit from the sale of inventories by the parent entity to the subsidiary:

D	Loan liabilities	100,000
Cr	Loans granted	100,000

D	Net profit for financial year (cost of goods sold)	50,000
Cr	Inventories	50,000

In summary, the consolidated balance sheet as at 31.12.20X1 is as follows:

	A	**B**	**Eliminations**	**Consolidated**
Assets				
Cash	150,000	70,000		220,000
Receivables	80,000	50,000		130,000
Inventories	50,000	200,000	-50,000	200,000
Loans granted	100,000	–	-100,000	0
Investment in subsidiary	200,000	–	-200,000	0
Goodwill	–	–	64,000-4,000	60,000
Non-current assets	320,000	280,000	20,000-1,000	619,000

Total	900,000	600,000	-271,000	1,229,000
Liabilities				
Suppliers	260,000	180,000		440,000
Loans	40,000	200,000	-100,000	140,000
Total	**300,000**	**380,000**	**-100,000**	**580,000**
Equity				
Minority interest	–	–	46,000+2,000–200	47,800
Share capital	400,000	100,000	-100,000	400,000
Retained earnings	100,000	40,000	-40,000	100,000
Net profit for financial year	100,000	80,000	–80,000+48,000+8,000–800–4,000–50,000	101,200
Total	**600,000**	**220,000**	**-171,000**	**649,000**
Total	**900,000**	**600,000**	**-271,000**	**1,229,000**

(c) Investment in the separate balance sheet of the parent entity

At the date of acquisition. or 30.06.20X1, the investment in the parent entity's separate balance sheet is recognised at cost, i.e. 200,000 euros:

D	Investment in subsidiary B	200,000
Cr	Cash	200,000

The investment in subsidiary is subsequently accounted for based on the policies provided in clause 63 consistently depending on the accounting method selected by the parent entity either (i) at cost of the subsidiary, (ii) at fair value of the associate subsidiary or (iii) using the equity method.

(i) Cost method – no additional accounting entries are made at the end of the financial year (in case the subsidiary's recoverable value as at the reporting date had fallen below its cost, an impairment of the investment should be recognised).

(ii) Fair value method – as the fair value of the subsidiary at 31.12.20X1 totals 300,000 euros, the fair value of the share (80%) belonging to the parent entity is 240,000 euros. The parent shall recognise a gain from the change in fair value in the amount of 40 000 euros:

D	Investment in subsidiary B	40,000
Cr	Gain from subsidiary	40,000

(iii) Equity method – the share of parent entity (80%) is added to the acquisition cost of subsidiary (200,000) in post-acquisition profit of subsidiary, less depreciation of

goodwill, and adjusted with differences arising from the purchase price allocation and unrealised profit or loss from intra-group transactions (as described in clause 92).

Parent entity's profit for 20X1 calculated using the equity method consists of the following components:

Subsidiary's profit after acquisition (60 000*80%)	**48,000**
Depreciation of goodwill (64,000, over eight years, half-year's expense)	-4,000
Assets whose fair value in the parent entity's purchase price allocation differed from their carrying amount on the subsidiary's balance sheet:	
– non-current assets (20,000*80%, over ten years, half-year's expense)	-800
– adjustment of profit on sale of inventories written down in purchase price allocation	+8,000
Elimination of unrealised profit from intra-group transaction (sale of inventories to subsidiary) (80% of 50,000)	-40,000
Total	**11,200**

Profit from subsidiary, calculated using the equity method (11,200 euros) is by 10,000 euros higher than profit calculated from subsidiary upon consolidation (being 1,200 euros after eliminations). The reason is that in consolidated statements, intra-group transactions are eliminated in full (in this case, sale of inventories to subsidiaries, on which 50,000 euros of profit was received), while under equity method, only the share of parent in unrealised profit is eliminated (in this case, 80% x 50,000 = 40,000 euros).

Parent entity records profit at equity method in amount of 11,200 euros and the carrying amount of subsidiary as at 31.12.20X1 is 211,200 euros.

D	Investment in subsidiary B	11,200
Cr	Gain from subsidiary	11,200

Example 1.2 – Accounting for an associate in the consolidated and separate financial statements

At 30.06.20X1, entity A acquired 40% of the shares of associate B for the price of 100,000 euros. As at 30.06.20X1, the carrying amount of the associate's equity was 160,000 euros. The carrying amounts of the assets and liabilities of the associate at the date of acquisition were approximately the same as their fair values, except for non-current assets whose fair value was 20,000 euros higher (the remaining useful life of these non-current assets whose fair value differs from the carrying amount was 10 years at the time of acquisition) and inventories whose fair value was 10,000 euros lower.

Balance sheet of associate B	**30.6.20X1**
Assets	
Cash	10,000
Receivables	20,000
Inventories	120,000
Non-current assets	300,000
Total	**450,000**

Liabilities	
Suppliers	190,000
Loans	100,000
Total	**290,000**
Equity	
Share capital	100,000
Retained earnings	40,000
Net profit for financial year	20,000
Total	**160,000**
Total	**450,000**

The net profit of the associate is 80,000 euros in 20X1, 20,000 of which was earned before 30.06.20X1 and 60,000 after 30.06.20X1. All inventories on the balance sheet at 30.06.20X1 had been sold by the end of the year. At 31.12.20X1, parent entity A sold inventories to its associate for 100,000 euros, the residual value of which was 50,000 euros on entity A's balance sheet. According to the management, the fair value of the associate at 31.12.20X1 is 300,000 euros (40% of this is 120,000 euros).
How to recognise the investment in the associate using the equity, cost and fair value method? The balance sheet of associate B as at 31.12.20X1 is the same as the balance sheet of the subsidiary provided in example 1.1.

At the date of acquisition, i.e. on 30.06.20X1, the investment in the associate on the investor's consolidated and separate balance sheet is recognised at cost which is 100,000 euros:

D	Investment in associate B	100,000
Cr	Cash	100,000

The investment in associate is subsequently accounted for based on the policies provided in clauses 60-64 consistently depending on the accounting method selected by the investor either (i) at cost of the associate, (ii) at fair value of the associate or (iii) using the equity method.

(i) <u>Cost method</u>

No additional accounting entries are made at the end of the financial year (in case the associate's recoverable value as at the reporting date had fallen below its cost, an impairment of the investment should be recognised).

(ii) <u>Equity method</u>

The starting point for the equity method is the purchase price allocation which is similar to the situation in example 1.1.

Acquired net assets	**Carrying amounts**	**Adjustments**	**Fair values**
Assets			
Cash	10,000	–	10,000
Receivables	20,000	–	20,000
Inventories	120,000	-10,000	110,000
Non-current assets	300,000	+20,000	320,000
Total	**450,000**	**+10,000**	**460,000**
Liabilities			
Suppliers	190,000	–	190,000
Loans	100,000	–	100,000
Total	**290,000**	**–**	**290,000**
Net assets	**160,000**	**+10,000**	**170,000**
Investor's ownership interest in net assets (40%)			**68,000**
Cost			**100,000**
Goodwill			**32,000**

Accounting under the equity method means that the initial cost of 100 000 euros is adjusted for the subsequent changes in the associate's equity, the elimination or depreciation/amortisation of the adjustment made in the purchase price allocation between the carrying amount and the fair value of net assets as well as the unrealised profits arising on transactions between the investor and the associate.

For the correct application of the equity method, from the time of acquisition, records should be kept of the reasons why the investor's share in the investee's equity (40% × 160 000 = 64 000) differs from the carrying amount of the investment in the balance sheet of the investor (100 000). In this example, the following comparison summarises these differences:

Investor's share in the associate's equity (40% of 160 000)	**64,000**
Goodwill	+32,000
Differences between the carrying amounts and fair values of net assets:	
-non-current assets (40% of 20,000)	+8,000
-inventories (40% of 10 000)	-4,000
Investment in the investor's balance sheet	**100,000**

Investor's profit for 20X1 calculated using the equity method consists of the following components:

Subsidiary's profit after acquisition (60 000*40%)	**24,000**
Depreciation of goodwill (32,000, over eight years, half-year's expense)	-2,000
Assets whose fair value in the investor's purchase price allocation differed from their carrying amount on the associate's balance sheet:	
– non-current assets (20,000*40%, over ten years, half-year's expense)	-400
– adjustment of profit on sale of inventories written down in purchase price allocation	+4,000

Elimination of unrealised profit from the mutual transaction (sale of inventories to associate) (40% of 50 000)	-20,000
Total	**5,600**

Hence, despite the fact that the associate recognised a profit of 60,000 euros in its financial statements from the time of acquisition until the end of 20X1, a profit of only 5,600 euros is recognised using the equity method in the financial statements of the investor:

Cr	Profit under equity method	5,600
D	Investment in the associate's shares	5,600

A comparison of the investee's equity and its carrying amount as at 31.12.20X1:

Investee's equity (220,000)*40%	**88,000**
Goodwill (32 000–2 000)	+30,000
Differences between the carrying amounts and fair values of net assets:	
– unamortised difference of non-current assets (8,000–400)	+7,600
Unrealised profits (inventories)	-20,000
Investment in the balance sheet of the parent entity	**105,600**

(iii) <u>Fair Value Method</u>

As the fair value of the associate totals 300 000 euros, the fair value of the share (40%) belonging to the investor is 120 000 euros. The investor recognises its gain from the change in fair value in the amount of 20 000 euros:

D	Investment in associate B	20,000
Cr	Gain from associate	20,000

NOTE 2 – BUSINESS COMBINATIONS OF ENTITIES UNDER COMMON CONTROL

Example 2.1 – Business combination involving entities under common control when the cost is lower than the carrying amount of acquired net assets

Entity A has two wholly owned subsidiaries B and C. The parent entity decides to sell subsidiary C to subsidiary B. The acquisition price is 3 000 000 euros and the carrying amount of C's net assets is 5 000 000 euros. A year later, the legal merger of B and C will be performed.

Accounting in consolidated financial statements

As the transaction occurs between entities under common control, the transaction must be accounted for using the adjusted purchase method in the consolidated financial statements of entity B.

The difference between the acquisition price and the carrying amount of entity C's net assets shall be recorded in the consolidated financial statements of entity B as the owner's additional contribution into entity B's equity (either under item “share premium" or in any other justified equity item):

D	Subsidiary C's assets and liabilities (at carrying amount)	5,000,000
C	Cash	3,000,000
C	Equity	2,000,000

The later legal merger of B and C is not a business combination for the purposes of this guideline and it does not have an effect on the consolidated financial statements of B.

Accounting in separate financial statements

Based on clause 86, entity B can choose between two alternative methods of accounting:

(i) The acquisition price is treated as cost:

D	Investment in subsidiary C	3,000,000
C	Cash	3,000,000

(ii) The carrying amount of acquired net assets is treated as cost:

D	Investment in subsidiary C	5,000,000
C	Cash	3,000,000
C	Equity	2,000,000

Starting from the moment of the legal merger, entity B derecognises the shares of entity C in its separate financial statements and starts to recognise the assets and liabilities as well as the income and expenses of entity C line by line (similarly to consolidated financial statements).

Example 2.2 – Business combination involving entities under common control when the cost is higher than the carrying amount of acquired net assets

How should the transaction of purchase and sale in the previous example 2.1 be recognised if B pays 8 million euros for 100% of the shares of C?

Accounting in consolidated financial statements

As the transaction occurs between entities under common control, the transaction must be accounted for using the adjusted purchase method in the consolidated financial statements of entity B.
The difference between the acquisition price and the carrying amount of entity C's net assets shall be recorded in the consolidated financial statements of entity B as a reduction of share capital.

D	Subsidiary C's assets and liabilities (at carrying amount)	5,000,000
D	Equity	3,000,000
C	Cash	8,000,000

Accounting in separate financial statements

Based on clause 86, entity B can choose between two alternative methods of accounting:

(i) The acquisition price is treated as cost:

D	Investment in subsidiary C	8,000,000
C	Cash	8,000,000

The fact that the cost of the subsidiary is significantly higher than the carrying amount of its net assets may mean that an impairment test should be performed to determine the recoverability of the investment based on the guideline ASBG 5 "Property, Plant and Equipment and Intangible Assets".

(ii) The carrying amount of acquired net assets is treated as cost:

D	Investment in subsidiary C	5,000,000
D	Equity	3,000,000
C	Cash	8,000,000

NOTE 3 – APPLICATION OF THE EQUITY METHOD TO TRANSACTIONS AFFECTING EQUITY

Entity A owns a 40% interest in the shares of associate B. How to recognise the following transactions at equity method?

(a) Payment of Dividends

Entity B pays its shareholders dividends of 100 units, of which to entity A in the amount of 40 and to the other shareholders in the amount of 60. The entry in the books of the investor:

D Cash	40
C Investment in the associate's shares	40

(b) Share capital increase

Entity B increases its share capital via private placement by issuing new shares to the existing shareholders in exchange for cash. How to recognise the increase of the share capital if:

(b.1) all the shareholders of entity B buy the new shares offered to them and the share of A in the associate does not change;

(b.2) only A buys the new shares offered to it and the share of A in the associate increases from 40% to 60%;

(b.3) all the shareholders of B except for A buy the new shares offered to them and the share of A in the associate decreases from 40% to 25%?

(b.1) If the share of the investor in the investee does not change during the increase of the share capital, the additional contribution to the equity of the investee shall be recognised as follows:

D Investment in the associate's shares
C Cash

(b.2) If the share of the investor in the associate increases during the increase of the share capital, a purchase price allocation shall be prepared similarly to the acquisition of the initial ownership interest. If the investor obtains control as a result of the increased share, the investee shall be considered to be a subsidiary and it shall be consolidated starting from the moment when the additional share is acquired.

(b.3) If the share of the investor decreases during the increase of the share capital of the investee (because shares are issued to the other shareholders), it shall be dealt with similarly to the sale of the share. The investor's share in the net assets of the investee after the issue less the investor's share in the net assets of the investee before the issue shall be recognised as profit or loss on sale in the income statement of the investor:

D Investment in associate
C Profit from the decrease of the share

or

D Loss from the decrease of the share
C Investment in associate

The potential reduction of the share capital shall be dealt with in the books similarly to the increase of the share capital of the investee.

(c) Formation of the legal reserve in the balance sheet of an associate

An associate increases its reserve capital by 100 units, by using the retained earnings.

Reclassification within the associate's equity from one item to another does not change the net assets of the associate and its value for the investor, therefore the transaction shall not be recognised in the financial statements of the investor.

NOTE 4 – EXAMPLES ON TRANSACTIONS WITH MINORITY INTEREST

Example 4.1 – Acquisition of minority interest

Parent A owns a 60% ownership interest in subsidiary B. Parent A's consolidated financial statements (including fair value adjustments made in the purchase price allocation) show the subsidiary's net assets of 3,500,000 euros at 31.12.20X1, allocated between the parent and minority shareholders as follows:

Net assets	**3,500,000**
incl. share attributable to parent (60%)	2,100,000
share attributable to minority interest (40%)	1,400,000

At 1.01.20X2, the parent acquired an additional 20% of the subsidiary's shares, paying 900,000 euros for them.

The carrying amount of the subsidiary's 20% minority interest in the consolidated financial statements of the parent is 700 000 euros (i.e. 1 400 000 / 40% * 20%). Therefore, the acquisition cost of the minority interest is 200,000 euros higher than its carrying amount (900,000 – 700,000 euros). The following entry shall be made in the consolidated financial statements:

D Minority interest	700,000
D Retained earnings	200,000
C Cash	900,000

Example 4.2 – Sale of minority interest

Same source data as in the example 4.1 but now the parent entity is selling 5% of the subsidiary's shares at the price of 300,000 euros at 1.01.20X2.

The carrying amount of the subsidiary's 5% minority interest in the consolidated financial statements of the parent is 175 000 euros (i.e. 1 400 000 / 40% * 5%). Therefore, the sale price of the minority interest is 125 000 euros higher than its carrying amount (300 000 – 175 000 euros).

The following entry shall be made in the consolidated financial statements:

D Cash	300,000
C Minority interest	175,000
C Retained earnings	125,000

NOTE 5 – EXAMPLES OF MERGERS AND DEMERGERS

Example 5.1A – Merger of a parent company with a subsidiary

On 31.12.20X0, Company A acquired 100% of the shares of company B at a price of EUR 100,000. In the course of the business combination, a purchase price allocation was prepared in which the net assets of Company B were adjusted to fair value:

Purchase price allocation as of 31.12.20X0:

Net assets acquired	**Carrying amounts**	**Adjustments**	**Fair values**
Assets			
Cash	10 000	0	10 000
Receivables	20 000	0	20 000
Inventories	120 000	-10 000	110 000
Non-current assets	300 000	20 000	320 000
Total	**450 000**	**10 000**	**460 000**
Liabilities			
Suppliers	190 000	0	190 000
Loans	200 000	0	200 000
Total	**390 000**	**0**	**390 000**
Net assets	**60 000**	**10 000**	**70 000**
Parent's share in acquired net assets			**70 000**
Cost			**100 000**
Goodwill			**30 000**

The balance sheets of companies A and B and the consolidated balance sheet as of 31.12.20X0 are as follows (in the balance sheet of the parent, an investment in a subsidiary is carried at cost):

Consolidation as of 31.12.20X0:

	A	**B**	**Adjustments**	**Consolidated**
Assets				
Cash	150 000	10 000		160 000
Receivables	80 000	20 000		100 000
Inventories	50 000	120 000	-10 000	160 000
Loans granted	100 000	0		100 000
Investment in subsidiary	100 000	0	-100 000	0
Goodwill	0	0	30 000	30 000
Non-current assets	320 000	300 000	20 000	640 000
Total	**800 000**	**450 000**	**-60 000**	**1 190 000**

Liabilities				
Suppliers	260 000	190 000		450 000
Loans	40 000	200 000		240 000
Total	**300 000**	**390 000**	**0**	**690 000**
Equity				
Share capital	300 000	10 000	-10 000	300 000
Retained earnings	100 000	30 000	-30 000	100 000
Net profit for financial year	100 000	20 000	-20 000	100 000
Total	**500 000**	**60 000**	**-60 000**	**500 000**
Total	**800 000**	**450 000**	**-60 000**	**1 190 000**

The owners of company A decided to merge companies A and B in such a way that the acquiring company is subsidiary B and the parent company A is the acquired entity. The balance sheet date of the merger is 31.12.20X1 and the share capital of subsidiary B will not change in the course of the merger.

The balance sheets and income statements of Companies A and B and the consolidated balance sheet and income statement as at 31.12.20X1 (immediately before the merger) are as follows:

Consolidation as at 31.12.20X1

BALANCE SHEET	**A**	**B**	**Adjustments**	**Consolidated**
Assets				
Cash	260 000	60 000		320 000
Receivables	120 000	30 000		150 000
Receivable from Company A	0	10 000	-10 000	0
Inventories [1]	100 000	120 000		220 000
Loans granted	50 000	0		50 000
Investment in subsidiary	100 000	0	-100 000	0
Goodwill [2]	0	0	27 000	27 000
Non-current assets [2]	320 000	280 000	18 000	618 000
Total	**950 000**	**500 000**	**-65 000**	**1 385 000**
Liabilities				
Suppliers	250 000	190 000		440 000
Liabilities to Company B	10 000	0	-10 000	0
Loans	40 000	200 000		240 000
Total	**300 000**	**390 000**	**-10 000**	**680 000**
Equity				
Share capital	300 000	10 000	-10 000	300 000
Retained earnings	200 000	50 000	-50 000	200 000
Net profit for financial year	150 000	50 000	5 000	205 000
Total	**650 000**	**110 000**	**-55 000**	**705 000**
Total	**950 000**	**500 000**	**-65 000**	**1 385 000**

INCOME STATEMENT	A	B	Adjustments	Consolidated
Revenue	900 000	400 000		1 300 000
Goods, raw materials and services [1]	-500 000	-200 000	10 000	-690 000
Miscellaneous operating expenses	-90 000	-60 000		-150 000
Staff costs	-100 000	-50 000		-150 000
Depreciation and impairment of non-current assets [2]	-50 000	-40 000	[3] -5 000	-95 000
Total operating profit	**160 000**	**50 000**	**5 000**	**215 000**
Financial income and expenses	-10 000	0		-10 000
Net profit for financial year	**150 000**	**50 000**	**5 000**	**205 000**

[1] Inventories discounted in the purchase price allocation were sold during the reporting year.
[2] Useful life 10 years.
[3] Additional amortisation of goodwill and non-current assets revalued in the purchase price allocation.

As of 31.12.20X1, Company B will recognise the assets and liabilities and income and expenses of both merged entities on a line-by-line basis using the same carrying amounts recognised in the consolidated accounts. Thus, Company B must:

- recognise all assets and liabilities of Company A (except investment in Company B) and liabilities in its balance sheet at the carrying amount of Company A;
- recognise its assets and liabilities at the value used for consolidation (including the recognition of goodwill);
- account for the change in net assets arising from the merger under an appropriate equity item.

Company B's balance sheet immediately before and after the entries of the merger as at 31.12.20X1

BALANCE SHEET	B before the entries for the merger	Assets and liabilities obtained from A	Additional entries resulting from the merger	B after merger entries
Assets				
Cash	60 000	260 000		320 000
Receivables	30 000	120 000		150 000
Receivable from Company A	10 000		[1] -10 000	0
Inventories	120 000	100 000		220 000
Loans granted	0	50 000		50 000
Investment in subsidiary	0	[2] 0		0
Goodwill	0	0	[3] 27 000	27 000
Non-current assets	280 000	320 000	[3] 18 000	618 000

Total	**500 000**	**850 000**	**35 000**	**1 385 000**
Liabilities				
Suppliers	190 000	260 000		450 000
Liabilities to Company B	0	10 000	[1] -10 000	0
Loans	200 000	40 000		240 000
Total	**390 000**	**310 000**	**-10 000**	**690 000**
Equity				
Share capital	10 000			10 000
Retained earnings	50 000		4,440,000	490 000
Net profit for financial year	50 000		[5] 155 000	205 000
Total	**110 000**	**0**	**595 000**	**705 000**
Total	**500 000**	**310 000**	**585 000**	**1 395 000**

[1] Receivables and liabilities between each other are eliminated.
[2] Investment in B is not included.
[3] Recorded at book value (from the consolidated accounts).
[4] In this example, the change in net assets is recognised under retained earnings.
[5] Net profit for financial year shall be equal to the net profit for financial year recognised in the consolidated accounts.

One of the base principles of preparing the Financial statements is to proceed from the economic substance of transactions. Although Company B has not been a parent and is therefore not required to prepare consolidated accounts, from an economic point of view it is the substantive successor to the group that existed between 31.12.20X0 and 31.12.20X1. Therefore, companies A and B prepare their own financial statements for the periods from 20X0 to 20X2 as follows:

- 20X0: A prepares consolidated financial statements (comparative data is A's unconsolidated data for 20X-1), B prepares separate financial statements;
- 20X1: A prepares the final balance sheet (since it is a company being merged), B prepares non-consolidated financial statements in terms of legal form, in which the data for the financial year are consolidated and the comparative information for 20X0 is from the Company A's consolidated financial statements of 20X0 (excluding share capital);
- 20X2: B prepares unconsolidated financial statements, comparative data for 20X1 is from company B's 20X1 report.

Example 5.1B — Merger of a parent company with a subsidiary

Company A (parent company) was founded on 1.03.20X1 and acquired Company B (a subsidiary) in a business combination between independent parties on 1.05.20X2. The Company B had been operating for more than ten years. 1.07.20X2 companies were merged, with company B legally being the acquirer.

If a subsidiary was acquired in a business combination between independent entities, the financial information of the parent are recognised in the reports of the merged entity from the beginning of the earliest period recognised in the financial statements (or since

the foundation of the parent, if later) and the financial information of the subsidiary from the moment of its acquisition (regardless of which entity is legally the acquirer and acquired).

The financial statements of the merged entity for 20X2 includes:

- Financial information of company A since its inception (1.03.20X1 - 31.12.20X2);
- Financial information of Company B from the moment of its acquisition, using the values estimated in the purchase price allocation (1.05.20X2 - 31.12.20X2).

Example 5.2A – Demerger of a company under common control

Company A has two owners, X and Y, which hold 70% and 30% stakes, respectively. One business operation is separated from Company A, which will be transferred to the new Company B. Shares in both companies are owned by the same owners. The net assets transferred shall be used as a non-monetary contribution to the share capital of the receiving Company B. The net assets transferred consist of:

- Receivables 50 000
- Inventories 30 000
- Non-current assets 70 000 (including a cost of €100,000 and accumulated depreciation of €30,000)
- Liabilities 50 000

Total net assets 100 000

In evaluating the usual value of the net assets transferred, assessed for a non-monetary contribution to Company B's share capital, the usual value of receivables, inventories and liabilities is equal to their carrying value, but that the usual value of non-current assets is €90,000. Therefore, the usual value of the net assets is €120,000 and the owner decided that the share capital of Company B to be created will be €120,000.

Since there has been no change in such a demerger in the assets owned by the owner as a whole, the reduction in the equity of one company must be equal to an increase in the equity of another company, so that the net assets transferred are recognised in Company B at the carrying amount of the net assets that it had in the accounts of Company A.

Entries in the accounts of company A:

C Receivables	50 000
C Inventories	30 000
C Cost of non-current assets	100 000
D Accumulated depreciation	30 000
D Liabilities	50 000
D Equity	100 000

NB! If Company A becomes a shareholder in Company B and not the owner of Company A, Company A recognises in its balance sheet the investment in Company B. The acquisition cost of this investment is equal to the carrying amount of the net assets transferred and no adjustment is made to other equity. The consolidated balance sheet of company A at the time of the demerger shall be equal to the balance sheet of company A before the demerger.

Entries in the accounts of Company B:

D Receivables	50 000
D Inventories	30 000
D Cost of non-current assets	100 000
C Accumulated depreciation	30 000
C Liabilities	50 000
C Share capital	120 000
D Equity	20 000

Example 5.2B – Demerger of a company to an independent party

Company A has two owners, X and Y, which hold 70% and 30% stakes, respectively. One business operation is separated from Company A, which is given to company B owned by shareholder Y. The share of shareholder Y in company A is cancelled. The net assets transferred shall be used as a non-monetary contribution to the share capital of the receiving company B.

The net assets transferred shall consist of:

- Receivables 50 000
- Inventories 30 000
- Non-current assets 70 000 (including a cost of €100,000 and accumulated depreciation of €30,000)
- Liabilities 50 000

Total net assets 100 000

In evaluating the usual value of the net assets transferred, assessed for a non-monetary contribution to Company B's share capital, the usual value of receivables, inventories and liabilities is equal to their carrying value, but that the usual value of non-current assets is €90,000. Therefore, the usual value of the net assets is €120,000 and shareholder Y decided that the amount of additional share capital of Company B would be €120,000.

In contrast to the situation described in example 5.2A, the company being demerged here has two owners, who so-called separate their businesses and remain independent of each other after the demerger. In such a case, Company B should consider whether the net assets received in the demerger constitute business and therefore the recognition of the business combination should be based on the principles of the purchase method.

In this example, in the course of a demerger, Company B has received business with its associated net assets in Company A and meets the definition of a business combination. Since the demerger saw a change in the control of such business (in company A it was owner X, while in company B it was owner Y), it is justified to use the purchase method to recognise such a business combination.

Entries in the accounts of Company A:

C Receivables	50 000
C Receivables	30 000
C Cost of non-current assets	100 000
D Accumulated depreciation	30 000
D Liabilities	50 000
D Equity	100 000

Entries in the accounts of Company B:

D Receivables	50 000
D Receivables	30 000
D Cost of non-current assets	90 000
C Accumulated depreciation	0

C Liabilities	50 000
C Share capital	120 000