KAI KASB

Research Report:

The Equity Method

December 5, 2014

Contents

Ⅰ. Background

- **The confusion around the current IAS 28 'Investments in Associates and Joint Ventures'**
  - **Problem**
    - **Not properly provide specific guidance in numerous cases**
    - **Even when the guidance is given, it is often vaguely stated**

      → Diverse guidance and/or interpretations
  - **Real problem**
    - **Providing more guidance could not be an answer**
      - **Exposure draft: *Equity Method: Share of Other Net Asset Changes* (March 2012)**
      - **Exposure draft: *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (June 2012)**
      - **Criticized by "inconsistencies within the standard"**
    - **Suggests that inconsistencies may exist not only in the current standard and the standard that is presently being developed but also in the standard that will be developed in the future.**

Ⅰ. Background

- **The cause of the confusion**
  - EFRAG's Short discussion paper on the Equity method (Feb. 2014)
    - Does not clearly present the concept of the equity method
    - Mixture of two concepts of the equity method
      - Consolidation technique (one-line consolidation)
      - Measurement basis for the investment
  - Examples
    - Example 1: Elimination of transactions between an investor and equity-accounted investees.
      - One-line consolidation: the transactions must be eliminated (IAS 28).
      - Measurement: the transactions do not need to be eliminated.
    - Example 2: Losses of equity-accounted investees in excess of their carrying value
      - One-line consolidation: the losses should be recognized
      - Measurement: the losses should not be recognized (IAS 28)

Ⅰ. Background

- **Amendments to IAS 27 ‘Separate Financial Statements’ (August 2014)**
  - **Allows the usage of the equity method in the separate financial statements.**
  - **Implies the extended usage of the equity method**
    - **Was limited only to (1) associates in (2) consolidated financial statements**
    - **Now extended to (1) associates and subsidiaries in (2) consolidated and separate financial statements**

	Associates only	Associates & Subsidiaries
Number of investees per investor	5. 93 firms	18. 75 firms
Equity method net income on total net income in consolidated financial statements	72. 85%	77. 36%
Equity method net income on parent company’s net income in separate financial statements*	59. 26%	113. 42%

- Companies who prepare consolidated financial statements in Korea’s KOSPI market (2011-2012)
- Computed by using absolute values

Ⅰ. Background

- **The first objective of the report**
  - **Develop internally consistent equity method**
    - **Introduce a new dimension, ‘scope of equity-accounted group’**
    - **introduced 3 alternative concepts of the equity method.**

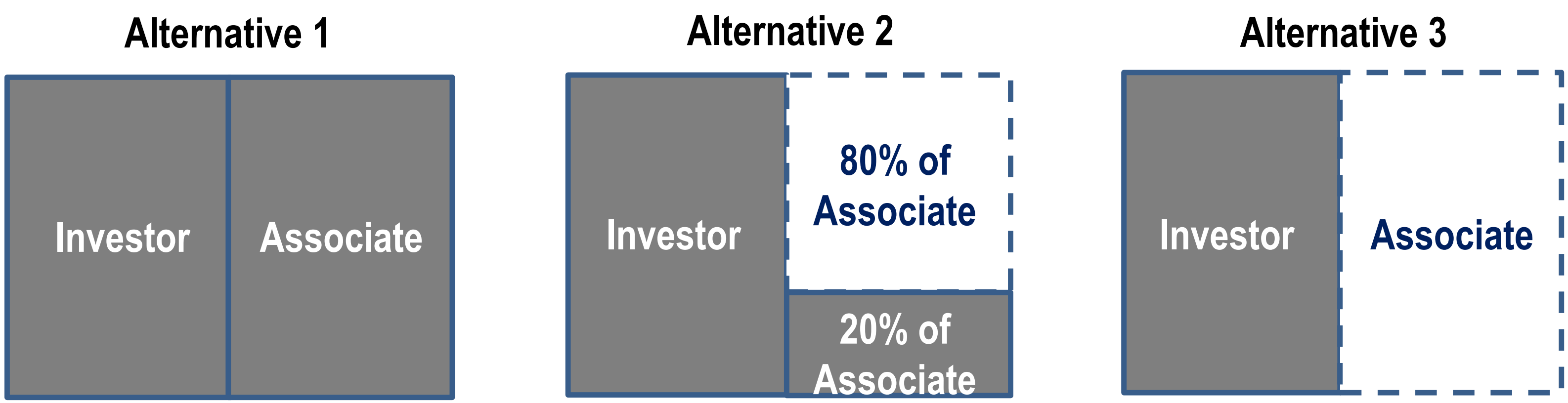
- **The second objective of the report**
  - **Present additional issues that the IASB should consider when carrying out the equity method research project**
    - **Korea’s extensive experience on the equity method**
    - **Ever since 1998, Korea has mandated the application of the equity method on the stand-alone (separate) financial statements.**

Ⅱ. New Concepts of Equity Method

- **Need for a new dimension**
  - The two underlying concepts of the equity method (i.e., one-line consolidation and measurement basis) are seemingly unrelated concepts
  - Without a dimension that regulates different concepts of the equity method, internally inconsistent standards having mixture of the different concepts will continue to exist
- **A new dimension: "scope of equity-accounted group"**
  - Equity-accounted group
    - '*a single economic entity'* consisting of an investor and its associates
    - a set of entities which is treated as a single economic entity in investor's financial statements by means of equity method.
    - EFRAG: proposes to use a term, 'boundaries of economic activities'
  - Scope of equity-accounted group
    - the extent of inclusion of the associate in the equity-accounted group.

Ⅱ. New Concepts of Equity Method

- **Three alternatives based on the new dimension**
  - depending on the scope of an equity-accounted group
  - In the following example, investor's share of the associate is assumed to be 20%



	Alternative 1	Alternative 2	Alternative 3
Scope of equity-accounted group	Investor and the associates	Investor and its share of the associates	Investor only
Nature of the investment	Business	A part of business	Financial asset

Ⅱ. New Concepts of Equity Method

Application 1: transactions with associates

- Example: An investor holding a 20% of an associate sells inventory to the associate for cash of CU 1,000. The carrying amount of the inventory was CU 500 in the investor's financial statements and the associate holds the inventory at the end of the reporting period.

Alternative 1	• The effect of the transaction between the investor and the associate should be entirely eliminated.			
	Dr) Sales	1,000	Cr) Equity-accounted investment	500
			COGS	500
Alternative 2	• Only 20% of the transaction should be eliminated			
	Dr) Sales	200	Cr) Equity-accounted investment	200
			COGS	200
Alternative 3	• The transaction is not eliminated			
	N/A			

Ⅱ. New Concepts of Equity Method

- **Application 2: Recognition of changes in other capital transactions of the associate**
  - **Example:** An investor holds a 20% share of an associate. The associate receives non-reciprocal capital contribution of CU 1,000 from its shareholder X in the current period. The associate accounts for this transaction as a capital transaction. The investor's ownership interest after the capital contribution remains the same at 20%.

Alternative 1	• Shareholder X is an owner of the equity-accounted group, and the transaction is a capital transaction with the owner of the equity-accounted group Dr) Equity-accounted investment 200 Cr) Equity 200
Alternative 2	• Shareholder X is NOT an owner of the equity-accounted group, and the transaction is NOT a capital transaction with the owner of the equity-accounted group. Dr) Equity-accounted investment 200 Cr) Profit 200
Alternative 3	• It is a transaction with third party. Dr) Equity-accounted investment 200 Cr) Account?* 200 * depending upon investment type (e.g., FVTPL, AFS…)

Ⅱ. New Concepts of Equity Method

- **COMPARISON - IAS 28 AND THREE ALTERNATIVES**

	Alternative 1	Alternative 2	Alternative 3
1. Initial recognition of the investment	★	★	★
2. Recognition of changes in net asset of the associate	★	★	
3. Recognition of changes in other capital transactions of the associate	★		
4. Uniform accounting policies	★	★	
5. Losses of associates in excess of their carrying value			★
6. Transaction with associates- to what extent gain/loss is eliminated		★	
7. Impairment of the investment	★	★	★
8. Consideration of assets held by the associate			★
9. Additional acquisition without status change		★	★
10. Additional acquisition with status changes from associate to a subsidiary		★	★

Ⅲ. Issues to Consider based on Korea's Experience

●The Equity Method under K-GAAP

Period I (before 1998)

Limited equity method

only to associates, only in consolidated financial statements

Period II (1998~2004)

Expanded application of equity method

to both associates and subsidiaries in the stand-alone financial statements

(to show the effect of consolidation on the stand-alone financial statements)

Period III (after 2004)

issued The Statement of Korean Accounting Standards of "Equity Method"

- incorporated Interpretation No. 42-59 (1999), 83 interpretations (2001-2004)
- Introduced Equity method for subsidiaries

Ⅲ. Issues to Consider based on Korea's Experience

Equity Method for Subsidiaries under K-GAAP

- Reason for the equity method for subsidiaries
  - Subsidiaries would not be the same as associates.
  - Expected that the equity method would naturally bring exactly the same effect of consolidation to the stand-alone financial statements.
    - However, there were many instances where the consolidated financial statements and the stand-alone financial statements were not consistent with each other.
- Equity method for subsidiaries
  - aligns net profit or loss and net assets of parent's stand-alone financial statements with the parent's share of the net profit or loss and net assets in the consolidated financial statements
  - with an exception where the losses of investees exceed their carrying value.

Equity Method for Subsidiaries under K-GAAP

The Equity Method for Subsidiaries and for Associates under K-GAAP

	Equity method for subsidiaries	Equity method for associates
Downstream transaction – elimination of unrealized profit/loss	Full elimination	Partial elimination
Additional acquisition/partial disposal without a change in control (or significant influence)	Change in equity	Additional acquisition – partial step-up Partial disposal – disposal profit/loss recognized
"other net asset changes" without a change of control (or significant influence)	Change in equity	Additional acquisition – partial step-up Partial disposal – disposal profit/loss recognized
Impairment losses for receivables due from subsidiaries	Adjustment is required in investor's profit/loss	N/A
Additional acquisition with a change in control	Acquisition method	Additional acquisition – partial step up

Ⅲ. Issues to Consider based on Korea's Experience

- **Sophisticated Equity Method for Associates under K-GAAP**
  - **Reason for the sophisticated equity method for associates**
    - **The impact of the equity method on financial statements is significant**
    - **The simple equity method under IAS 28 cannot capture the economic substance of a variety of transactions.**
  - **Additional guidance developed in K-GAAP which depicts the nature of transactions**
    - **When associates issue preference shares**
    - **Allocation of impairment loss**
    - **When there is a change in other net assets**
    - **And many other guidance/instances**

Example: Allocation of impairment loss

- **Company A acquired Company B as an associate by obtaining 30% of Company B's shares at the beginning of 2001. In 2001, Company B reported profit of CU 200, and other comprehensive income of CU 200. In 2002, Company A decided that it should recognize an impairment loss of CU 60 for Company B**

K-GAAP

- the investor's share of OCI in the associate is recycled.

Dr) Impairment loss	30	Cr) Associate-B	60
OCI-Associate	30		

IAS 28

- the investor's share of OCI in the associate is NOT recycled.

Dr) Impairment loss	30	Cr) Associate-B	60

- **Under IAS 28, the investor's share of the associate's OCI is not reversed. Then, even when the investor recognizes the impairment loss up to the total book value of the associate, its share of accumulated other comprehensive income is still presented on the investor's statement of financial position.**

IV. Comment letters

- **Urgency of revising IAS 28**
  - All constituents agree
    - that the conceptual basis for the equity method is unclear, which creates difficulty in practice,
    - and that it is urgent to clarify the conceptual basis and revise IAS 28.
- **Comments on the conceptual basis of the equity method**
  - Three constituents support our approach of considering the scope of equity-accounted group.
    - European Financial Reporting Advisory Group (EFRAG)
    - NZ Accounting Standards Board
    - Mexican Financial Reporting Standards Board
  - Two constituents view the equity method as a measurement basis
    - South African Financial Reporting Standards Committee
    - Australian Accounting Standards Board

V. Questions

- **In the past, the concept of equity method contrasted between the concept of one-line consolidation and measurement basis.**
  - Which one do you think is more appropriate for the equity method? One-line consolidation, measurement, both, or neither?

- **This report suggests three alternative concepts of equity method based on a new dimension, the scope of group.**
  - Do you think ‘scope of group’ is an appropriate dimension?
  - Do you think that there are other dimensions to establish the concept of the equity method?
  - If ‘scope of equity-accounted group’ is used for the equity method, what could possibly be the features of ‘equity-accounting group’ (what would be the determinants of ‘equity-accounted group’)?

V. Questions

- **In Korea, associates and subsidiaries take up a significant portion of financial statements. Since the amendment of IAS 27 is published, we believe, the equity method will gain even more importance as it is applied to both associates and subsidiaries and presented in both consolidated and separate financial statements.**
  - **Do you have any statistics that show the impact of the equity method on financial statements in your jurisdictions?**
  - **Do you agree that the equity method will become more important?**

- **Korea regulates different equity methods for associates and subsidiaries on the separate financial statements.**
  - **Do you have the same experience as in Korea?**
  - **Do you agree that equity method should be defined differently for the associates and subsidiaries?**

Thank you