

Research Report No. 35
The Equity Method

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Research Report: The Equity Method

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Korea Accounting Standards Board

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EXECUTIVE SUMMARY

1. CHAPTER 1. INTRODUCTION

CONFUSION AROUND THE EQUITY METHOD

1. There have been many controversies regarding the current IAS 28 'Investments in Associates and Joint Ventures.' The current IAS 28 is criticized for not properly providing specific guidance in numerous cases, and even when the guidance is given, it is often vaguely stated. As a result, diverse guidance has been executed by each major accounting firm on a case-by-case basis. Consequently, there have been numerous requests and opinions on the need for more specific additional guidance for consistent application of the equity method.
2. The controversies exist not only for the currently effective IAS 28 but also for the process of developing additional guidance on IAS 28. In December 2012, as part of the narrow scope project for IAS 28, the IASB published the Exposure Draft. In their comments, respondents believe that this ED includes inconsistencies within the standard. Arguments and controversies such as these serve as a sign that inconsistencies may exist in not only the current standard and the standard that is presently being developed but also in the standard that will be developed in the future.

THE CAUSE OF THE CONFUSION

3. The biggest attribute for such confusion is that the concept of the equity method is not clearly presented in the current IAS 28. Traditionally, there have been two viewpoints regarding the concept of the equity method. One viewed the equity method as a consolidation technique (one-line consolidation) and the other as a measurement basis for the investment. However, IAS 28 does not clarify which of these two viewpoints is the underlying concept of the equity method.¹ Actually, the current IAS 28 implies both of these two viewpoints.
 - 3.1. One example is the elimination of transactions between an investor and equity-accounted investees. If one-line consolidation is the concept of the equity method, the transactions must be eliminated. On the other hand, if measurement is the concept of the equity method, then the transactions do not need to be eliminated. The current IAS 28 is in line with the one-line consolidation concept.
 - 3.2. The current IAS 28 also contains accounting methods that are much more related to the measurement basis. For example, IAS 28 requires the investor not to recognize the losses of equity-accounted investees in excess of their carrying value. If the concept of equity method is

¹ It is not a problem confined only to IAS 28. IAS 21 'The Effects of Changes in Foreign Exchange Rates' also does not define the purpose of the foreign currency translation, resulting in inconsistencies in many areas within the standard.

one-line consolidation, the losses of equity-accounted investees need to be recognized by the investor in any circumstances.

IMPORTANCE OF THE EQUITY METHOD

4. Since the equity method has been applied only to associates² for the consolidated financial statements, one could mistakenly consider that the effect of the equity method is immaterial and thus that the confusions around the equity method need not be taken seriously. However, the impact of the equity method on financial statements is significant. Take the listed companies in Korea's KOSPI market, for example, the average carrying value of equity-accounted investments in associates in 2011-2012 accounts for 7.77% of the total assets of the consolidated financial statements. The equity method related profit or loss accounts for 72.85% of the total net income of the consolidated financial statements.
5. In August 2014, the IASB published the narrow amendments to IAS 27 'Separate Financial Statements,' allowing the usage of the equity method in the separate financial statements. This amendment allows the extended usage of the equity method. In the past, the usage of the equity method was limited only to associates in consolidated financial statements; however, it will be extended not only to associates but also to subsidiaries. Then, we can easily imagine that the impact of the equity method on financial statements will become even greater, and that the equity method will affect the separate financial statements as well.

THE OBJECTIVES OF THIS REPORT AND THE ISSUES DISCUSSED IN THIS REPORT

6. The objective of this report is to present issues that we believe the IASB should consider in amending IAS 28, as well as to present possible alternative ways to resolve ongoing issues regarding the equity method. More specifically, the remainder of this report consists of the following main parts.
 - 6.1. Chapter 2: The history of the equity method has been reviewed. In addition, we have compared the GAAPs among Germany, the USA and Korea. From the review and the comparison, we were able to find what has been considered as the concept of equity method and on what concept each jurisdiction has based their equity method accounting.
 - 6.2. Chapter 3: By introducing a new dimension called 'scope of equity-accounted group,' we have introduced 3 alternative concepts of the equity method. We proposed how accounting standards shall differ for each alternative concepts, and also analyzed why such inconsistencies are still present within the current IAS 28.

² In this paper, associates includes both associates and joint ventures.

6.3. Chapter 4: Based on experience of Korea, we presented additional issues that the IASB should consider when carrying out the equity method research project, including the expected issues from allowing the equity method for the separate financial statements. Ever since 1998, Korea has mandated the application of the equity method on the stand-alone financial statements. Additionally, prior to the adoption of IFRS, the equity method-applied stand-alone financial statements were deemed as the primary financial statements in Korea. Therefore, Korea has extensive experiences of resolving issues that occurred from applying the equity method to the stand-alone financial statements.

6.4. Chapter 5: By using market-based research, we have tested whether the equity method-applied separate financial statements provide more valuable information, compared to the cost method. We found that the information users value the information provided by the equity method.

2. CHAPTER 2. EQUITY METHOD IN GERMAN GAAP, US GAAP AND KOREAN GAAP

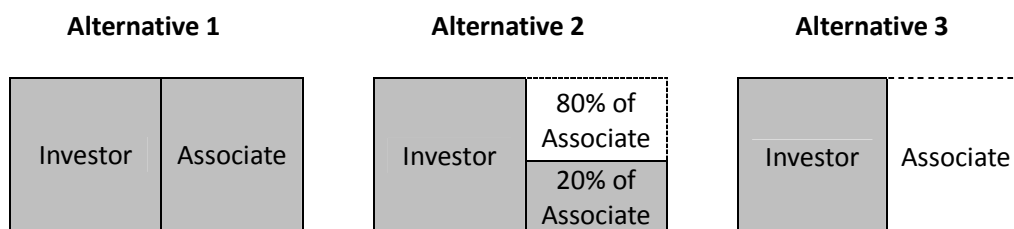
7. We have compared the GAAPs among Germany, the USA and Korea to understand what has been considered as the concept of equity method and on what concept each jurisdiction has based their equity method accounting.
8. Under German GAAP, the equity method for the associates is applied only in the consolidated financial statements to show the effect of consolidating associates. This accounting treatment is more consistent with one-line consolidation. However, characteristics of measurement such as not enforcing the uniform accounting policy also exist in German GAAP.
9. The accounting treatment for associates under US GAAP seems to put more emphasis on measurement than one-line consolidation: 1) fair value option is allowed for investment in associates, 2) uniform accounting policy between an investor and its associates is not required, and 3) the accounting for financial assets is applied for recognizing impairment of investments in associates. Nonetheless, US GAAP does not completely eliminate the one-line consolidation basis, e.g. unrealized profits or losses from transactions between the investor and the associates are eliminated.
10. The equity method has been developed in Korean GAAP (K-GAAP) as a substitute for consolidation, i.e. one-line consolidation, therefore, numerous aspects of consolidation basis could be easily found in K-GAAP. However, once again, the measurement basis is not completely precluded.
11. In summary, the equity method has been developed very distinctly in Germany, the USA and Korea. In the case of Germany and Korea, the equity method was applied as a substitute for consolidation. However, the characteristics of measurement basis were not completely precluded. In the case of the USA, more emphasis have been put on the measurement basis such as allowing the fair value option; however, even US GAAP also does not completely exclude the consolidation basis.

Consequently, the concept of equity method which has been developed in each jurisdiction is not exclusively on a consolidation basis or a measurement basis.

3. CHAPTER 3. PROPOSAL OF POSSIBLE CONCEPTS OF THE EQUITY METHOD AND THEIR APPLICATIONS

A NEW DIMENSION (SCOPE OF EQUITY-ACCOUNTED GROUP) AND THREE ALTERNATIVE CONCEPTS OF EQUITY METHOD

12. Without a dimension that regulates different concepts of the equity method, internally inconsistent standards having mixture of the different concepts will continue to exist, similar to the current accounting standards for the equity method. Therefore, in this report, we propose the new dimension, “*scope of equity-accounted group*.”³ Based on this dimension, we create alternative equity method accountings that are more internally consistent.
13. Equity-accounted group is ‘*a single economic entity*’ consisting of an investor and its associates. An equity-accounted group may include the associate as a whole, a part of the associate, or none of the associate. Thus, scope of equity-accounted group is determined by the extent of inclusion of the associate in the equity-accounted group. More specifically, depending on the scope of an equity-accounted group, we could create three alternative concepts of equity method. The schematic view of the associate’s assets and liabilities that are included in the equity-accounted group (the shaded part of the diagram) under the three alternatives are presented in the table below. It is assumed that investor’s share of the associate is 20%.



14. Alternative 1 is a concept that considers the associate as a part of the equity-accounted group, therefore, all of the associates’ assets and liabilities are assumed to be owned by the investor. The concept of group is applied not only to subsidiaries, but also extended to associates. Since the associate is presumed to be a part of the equity-accounted group, Alternative 1 uses the same concept of consolidation. Thus, amounts of the associate’s net profit and net asset attributable to

³ The term ‘equity-accounted group’ is similar to the term ‘group’ under IFRS 10, which consists of a parent and its subsidiary. Both terms define the extent of entities that constitute a single economic entity. While ‘group’ under IFRS 10 is a set of entities which is treated as a single economic entity in consolidated financial statements, ‘equity-accounted group’ is a set of entities which is treated as a single economic entity in investor’s financial statement by means of equity method. In the comment letter, EFRAG proposes to use a term, ‘boundaries of economic activities,’ instead of the scope of equity-accounted group (please see Appendix 2 and 3).

the investor are determined by applying the same logic. When the associate's net asset changes, the change could be attributable to the investor and other owners of the associate. That amount attributable to the investor is presented in one line by adjusting the investor's equity-accounted investment.

15. Alternative 2 is a concept that narrows down the scope of equity-accounted group to the investor's share of the associates. By presuming only the investor's share of associates as a part of the equity-accounted group, under Alternative 2, only a part of the associate's assets and liabilities belongs to the investor. In other words, the associate is included in the equity-accounted group, similar to Alternative 1. However, not 100% of the associate, but only the investor's share based on the investor's ownership of the associate is included in equity-accounted group.
16. Alternative 3 confines the scope of equity-accounted group to only an investor. Alternative 3 is a concept that does not consider the associate as a part of the equity-accounted group, so the investor does not recognize the assets and liabilities of the associate as its own. Thus, under Alternative 3, the equity-accounted investments could be viewed as one of the financial assets. Traditionally, cost method and fair value method have been regarded as measurement bases for financial assets. However, under this alternative, the equity method could be regarded as another measurement basis for financial assets. The equity method would measure the value of the investment based on the net assets of the associate.
17. Alternative 1 is a concept close to the equity method as one-line consolidation, and Alternative 3 is close to the equity method as a measurement basis. Although Alternative 2 is somewhat similar to the equity method under the current IAS 28, this is an internally consistent concept unlike the current equity method under IAS 28. It should be noted that the new dimension (scope of equity-accounted group) enables us to place all three alternatives, which are seemingly unrelated, on one continuum. Scope of equity-accounted group can be seen as one of the dimensions that could possibly define the concept of the equity method based on the relationship between the investor and its associate-i.e., whether or not the associate forms an equity-accounted group with the investor.

The Summary of the Alternatives

	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

APPLICATION OF THE ALTERNATIVES TO TRANSACTION WITH ASSOCIATES

18. In order to understand how each alternative of the equity method could be applied to typical transactions, assume a case where an investor owns 20% of an associate and the investor sold land to the associate with a gain of CU (currency unit) 100 upon disposal of the land.

18.1. For Alternative 1, since the investor and the associate are considered as part of one equity-accounted group, the transaction between the two entities needs to be eliminated in full. In other words, the profit of CU 100 from disposal should be eliminated completely.

18.2. For Alternative 2, when the transaction occurs, 80% of the transaction is considered to be a transaction outside the equity-accounted group and the remaining 20% is considered to be a transaction within the equity-accounted group. Therefore, adjustments need to be made in the investor's financial statements to exclude only 20% of the transaction as this is considered as an internal transaction within the equity-accounted group. In other words, out of the disposal gain of CU 100, only CU 20 is considered to be profit/loss arising from the internal transaction and eliminated.

18.3. For alternative 3, since the associate is not considered as a part of the equity-accounted group, no adjustment is necessary to eliminate the impact of the transaction between the two entities.

COMPARISON - IAS 28 AND THREE ALTERNATIVES

19. The table below summarizes the current IAS 28 (2011) and shows how it reflects the 3 alternatives. As shown in the table, it is evident that the current IAS 28 (2011) contains all 3 alternatives' concepts mixed therein.

	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		★	★

4. CHAPTER 4. ISSUES TO CONSIDER BASED ON EXPERIENCES OF KOREA UNDER KOREAN GAAP

20. The equity method has been developed as one of the most important accounting standards in Korea. Ever since 1998, Korea has mandated the application of the equity method on the stand-alone financial statements. The major objective was clear: to bring the effect of consolidation into the stand-alone financial statements. Since the stand-alone financial statements were deemed as the primary financial statements, the Korean Accounting Standard Board (KASB) purported to show the effect of consolidation in the stand-alone financial statements.
21. Even though the objective was clear, various issues emerged in practice, and discussions and research on equity method were actively carried out to address these issues. For example, from 2001 to 2004, the KASB provided 83 Interpretations in response to the inquiries on the equity method, and the Financial Supervisory Service (FSS) also provided a large number of responses to consultations from companies.
22. In August 2014, the IASB published the narrow amendments to IAS 27 'Separate Financial Statements', allowing the usage of the equity method in the separate financial statements. The amendment implies two major changes in the influence of the equity method. One is that the equity method will be extended to subsidiaries, and the other is that the equity method will affect the separate financial statements, which requires even more sophisticated equity method for associates. Based on the experience of Korea, we would like to advise the IASB that these changes should not be taken lightly, which is described below.

CHANGE 1: EQUITY METHOD FOR SUBSIDIARIES UNDER K- GAAP

23. In 1998, K-GAAP required the investor to apply the equity method not only to associates but also to subsidiaries when it prepares the stand-alone financial statements. The KASB did not expect any problem when it made the requirement. The KASB expected that the equity method would naturally bring exactly the same effect of consolidation to the stand-alone financial statements because theoretically the equity method is one-line consolidation. However, there were many instances where the consolidated financial statements and the stand-alone financial statements were not consistent with each other.
24. In order to address this problem, the KASB introduced distinct rules of equity method for subsidiaries in 2004 because it believed that at least the effect of subsidiaries should be the same between the separate financial statements and the consolidated financial statements. Therefore, the equity method accounting for subsidiaries was devised to align 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. The only exception is the case where the losses of subsidiaries exceed their carrying value.

25. Even though the major idea may look very simple, as summarized in the table below, the equity method for subsidiaries produced many accounting treatments different from the equity method for associates.

Major Differences between 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

CHANGE 2: SOPHISTICATED EQUITY METHOD FOR ASSOCIATES UNDER K-GAAP

26. The equity method described in the current IAS 28 (2011) is rather simple. The equity method under K-GAAP was also as simple as the one in the current IAS 28 when it was adopted for the first time in 1998. However, the KASB realized that there are a variety of transactions where the simple rules are hard to apply. This issue has been considered very seriously in Korea because the simple equity method cannot capture the economic substance of the transaction, and because the equity method has a significant impact on the stand-alone financial statements, which were the primary financial statements in Korea. Thus, K-GAAP has developed many additional guidance which could depict the nature of the transactions. The followings are some of the examples.

When associates issue preference shares

27. Preference shareholders could have a variety of entitlements to net profit distribution such as full participation, partial participation, etc. Therefore, K-GAAP provides guidance on how an investor should consider various conditions and entitlements of the preference shares in applying the equity method to the transaction where the associates issue preference shares. However, the current IAS 28 (2011) remains silent on this matter. Consequently, listed companies in Korea now often

encounter practical difficulties due to the lack of specific guidance.

Allocation of impairment loss

28. When an investor recognizes impairment loss for investment in associates, the investor's share of the associate's OCI is required to be recycled under K-GAAP. This is to provide the consistency for both impairment loss and accounting for change in net assets of the associates. However, IAS 28 recognizes impairment loss for the associates in current profit or loss without recycling OCI, which results in the following problem: Even when the investor recognizes the impairment loss up to the total book value of the associate, its share of accumulated OCI is still presented on the investor's statement of financial position.

OTHER ISSUES WHEN THE EQUITY METHOD IS ALLOWED IN THE SEPARATE FINANCIAL STATEMENTS

29. Besides the two major changes described above, we believe, the amendment of IAS 27 (2014) may cause a number of other issues that should be considered by the IASB.
30. First, considerations should be given to what the objective of the separate financial statements is and what information should be provided through the separate financial statements. Currently, the separate financial statements are produced to provide information of a single-entity as supplemental information to the consolidated financial statements. In other words, the separate financial statements are purported to provide differentiated information from the consolidated financial statements. However, since the equity method is allowed for subsidiary, associate and JV investment as stated in the amendment, the information provided by the separate financial statements will be redundant to that of the consolidated financial statements, which obscures the objective and the role of the separate financial statements.
31. Second, consideration should be given to whether the equity-method-based separate financial statements will provide more valuable information to the information users compared to the non-equity-method-based separate financial statements. Research in Korea suggests that when the equity method is applied to the separate financial statements, the information usefulness may in fact decrease. Then, we can reasonably expect that the amendment would make the information derived from the separate financial statements have no incremental value over the information provided by the consolidated financial statements.
32. Third, it should be taken into account that many countries adopted IFRS in recent years, and that they have gone through difficult times with enactment and amendment of major standards and regulations in the process of IFRS adoption. For example, in 2011, Korea has amended various regulations upon adopting IFRS, especially to reflect the differences between the stand-alone financial statements under K-GAAP and the separate financial statement under IFRS. The

information users of Korea have also been painfully adapting themselves to the separate financial statements. However, since the equity method is allowed for the separate financial statements, then confusion will arise again for regulators in amending regulations and for the information users in adapting themselves to the 'new' separate financial statements.

CHAPTER 5. VALUE RELEVANCE OF THE EQUITY METHOD – A MARKET-BASED STUDY

33. This chapter provides empirical evidence on the relative usefulness between the equity method and the cost method using listed companies in the Korea stock market. Based on the value relevance research framework originally developed by Ohlson (1995), this study tests the usefulness of the equity method by examining the difference in value relevance between the cost method and the equity method. We also examine under what circumstances the equity method can provide more useful information.
34. We find that the equity-method-applied financial statements provide more value relevant information than cost-method-applied financial statements. Moreover, when the equity method book value and equity method net income of associates are separated from those attributable to the controlling shareholders, the information becomes even more value relevant. These results suggest that the equity method may provide more value relevant and decision useful information to the users of financial statements, especially when more detailed information about the associates are given separately.

CHAPTER 6. SUMMARY AND CONCLUSION

SUMMARY OF THIS REPORT

35. We introduced three alternative concepts of the equity method by using a new dimension called "scope of equity-accounted group." Since we use the new dimension, we were able to incorporate all the existing concepts of the equity method as well as to create internally consistent equity methods. Alternative 1 and Alternative 3 can be viewed to be consistent with the one-line-consolidation and the measurement basis, respectively. Alternate 2 can be viewed as a mixture of the one-line consolidation and the measurement basis but without any inconsistencies within.
36. We also addressed additional issues that need to be considered by the IASB upon carrying out the research project on the equity method and that could be raised from the issuance of the amendment of IAS 27 (2014). From 1998 through 2011, Korean companies were mandatorily required to apply the equity method in their stand-alone financial statements. Therefore, Korea has accumulated abundant experiences of resolving issues that have taken place in applying the equity method to the stand-alone financial statements. This paper does not include many issues that are considered to be extremely technical. However, we can share those issues with the IASB upon the IASB's request.

ADDITIONAL ISSUES TO BE CONSIDERED

37. In this report, we proposed the new dimension, i.e., the scope of equity-accounted group, and presented three alternatives based on the dimension. However, we did not attempt to judge which of the alternatives would serve as the best option. The judgment could be based upon various interested parties' opinions and discussions. But, we believe that in order to make meaningful judgment, before looking for the opinions of various interest parties, the IASB needs to start research on the following issues:
38. First of all, the IASB needs to clearly define the assets subject to the equity method (i.e., equity-accounted investments) and their characteristics. This is important for two reasons. One is that, only when we define what the key characteristics of these assets are and provide reasoning on why and how these assets are distinguished from other similar assets, we can justify why the equity method should be applied to the equity-accounted investments. The other, the clear definition of the assets subject to the equity method and their characteristics should help the IASB judge which concept of the equity method and which equity method accounting faithfully reflects the equity-accounted investments.
39. Currently, we use the concept of "significant influence" and "20% rule" to define the assets subject to the equity method. However, we still do not share a clear understanding on what is significant influence and how it is different from the concept of "control." Moreover, according to Nobes (2002), the 20% rule does not have any logical basis of reasoning whatsoever. Therefore, we suggest the IASB clearly define what is an equity-accounted investment. Without a clear definition, it would never be possible to judge which concept of the equity method and which equity method accounting faithfully represents the equity-accounted investments.
40. When contemplating on this issue, the IASB need not to select only one between the one-line consolidation and the measurement basis. As we have suggested in this report, the IASB should try to develop other dimensions such as the scope of equity-accounted group.
41. In addition, the IASB may need to explore whether the equity method is absolutely necessary. Resultant of such research, the IASB may reach the conclusion that special accounting such as the equity method may not be necessary. More specifically, under the historical cost-based accounting, the equity method was able to provide relevant information. However, we may need to contemplate whether the equity method accounting also provides relevant information under the fair value-based accounting. For example, the equity method would not be able to provide relevant information any more when equity method applicable investment has an active market (i.e., level 1 inputs of the fair value hierarchy).

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CHAPTER 1 INTRODUCTION

1. This report presents issues that we believe should be addressed by the IASB on the equity method research project. First, the most fundamental application issue regarding the equity method is the vagueness of its underlying concept, i.e. whether it serves as one-line consolidation or measurement basis. To facilitate the IASB's further steps to address this issue, this paper uses a new dimension, "scope of equity-accounted group" and presents three alternative concepts of the equity method, as well as explains how the equity method accounting standard may vary under each of the three alternative concepts. Secondly, based on our experiences in Korea, this paper presents additional issues that we believe the IASB should consider in carrying out the equity method research project. From 1998 to 2011, prior to the adoption of IFRS, Korean GAAP required the application of equity method in the stand-alone financial statements. Therefore, Korea has accumulated extensive experience in resolving equity method-related issues, which could provide valuable insights to the IASB in amending IAS 28. Lastly, this paper reports the results of the empirical research regarding the value relevance of the equity method. This research shows how much information users in the capital market actually value the information provided by the equity method. It shows the importance of the equity method, not on a conceptual level but on an empirical and practical level.
2. It should be noted that the purpose of this paper is not to provide a final version of a new standard on the equity method. The purpose of this paper is to provide a starting point of discussions for developing a better standard for equity method.

CONFUSION AROUND THE EQUITY METHOD

3. There have been many controversies regarding the current IAS 28 'Investments in Associates and Joint Ventures.' The current IAS 28 is criticized for not properly providing specific guidance in numerous cases, and even when the guidance is given, it is often vaguely stated. As a result, diverse guidance has been executed by each major accounting firm on a case-by-case basis, therefore causing inconsistencies within the standard. Consequently, there have been numerous requests and opinions on the need for more specific additional guidance for consistent application of the equity method.
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THE CAUSE OF THE CONFUSION

5. The biggest attribute for such confusion is that the concept of the equity method is not clearly presented in the current IAS 28.
6. Traditionally, there have been two viewpoints regarding the concept of the equity method. One viewed the equity method as a consolidation technique (one-line consolidation) and the other as a measurement basis for the investment. However, IAS 28 does not clarify which of these two viewpoints is the underlying concept of the equity method¹. This is a very serious issue because the result of this vagueness of the concept of the equity method is the cause of the constant confusion for what equity method accounting should be. This is described in more detail in the followings.
7. First, the equity method accounting standard may vary depending upon the concept of the equity method. In the case of IAS 28, however, the concept of the equity method is not clearly stated, and thus there already exist inconsistencies within the standard.
 - 7.1. One example is the elimination of transactions between an investor and equity-accounted investees. If one-line consolidation is the concept of the equity method, the transactions with equity-accounted investees must be eliminated. This is because in the consolidation process, the investor and the equity-accounted investees are assumed to be one group. On the other hand, if measurement is the concept of the equity method, then the transactions with equity-accounted investees do not need to be eliminated. Since there is no concept of 'group' under the measurement basis, there is no basis to eliminate the transactions with equity-accounted investees. The current IAS 28 requires the investor to eliminate unrealized profits or losses from the transactions with equity-accounted investees, which is in line with the one-line consolidation concept.
 - 7.2. The current IAS 28, however, contains accounting methods that are much more related to the measurement basis. For example, IAS 28 requires the investor not to recognize the losses of equity-accounted investees in excess of their carrying value. If the concept of the equity method is one-line consolidation, the losses of equity-accounted investees need to be recognized by the investor in any circumstances. The accounting standard in which the losses of equity-accounted investees are not recognized under certain circumstances as in the current IAS 28 concurs more with the measurement basis.
8. Secondly, the concept of the equity method could serve a role similar to that of the Conceptual Framework. Because the concept of the equity method is not clearly stated, the following additional problems occur.

¹ It is not a problem confined only to IAS 28. IAS 21 'The Effects of Changes in Foreign Exchange Rates' also does not define the purpose of the foreign currency translation, resulting in inconsistencies in many areas within the standard.

- 8.1. When specific accounting guidance is not provided, financial statement preparers and accounting firms would create a new one themselves to accommodate their needs. In doing so, since a specific concept of the equity method is not clearly stated, it is very likely that they would eventually develop accounting methods different from one another. Additionally, their own interpretations regarding the current standard may not necessarily be the same. Actually, there are already inconsistencies in many different cases between accounting firms because there is no commonly agreed concept of the equity method.
- 8.2. When the IASB adds new guidance or provides an interpretation for the current standard in regards to the equity method, it is extremely difficult for the IASB to develop guidance or interpretation consistent with the current IAS 28. One example is the ED published in November 2012. The ED was developed based on the underlying concept that the equity method is one-line consolidation. In response to this ED, many concerns have been raised questioning whether the equity method is one-line consolidation. The seriousness of the problem can be spotted by observing the fact that the newly published ED was criticized for the same evolving issue that has been controversial for decades.
9. Lastly, because the concept of the equity method is not explicitly defined, the market may fall into confusion regarding how to use the information produced by the equity method under the current IAS 28. This will eventually result in degrading the usefulness of accounting information produced by the equity method.

IMPORTANCE OF THE EQUITY METHOD

10. Recognizing the problems of the current equity method caused by the lack of a clear concept, the IASB included the equity method in its research project agenda, and issued its first staff paper on the equity method in May, 2014. We believe it is the right timing to start the research project because the impact of the equity method on financial statements is significant as shown below.

Importance of the equity method when the equity method is applied only to associates

11. Under IFRS where the consolidated financial statements are the main financial statements, the equity method has been applied only to associates.² Nonetheless, the impact of the equity method is significant as shown in Table 1-1.
 - 11.1. First, associates take up a rather significant portion of the consolidated financial statements. For the listed companies in Korea's KOSPI market, the average carrying value of equity-accounted investment for associates in 2011-2012 accounts for 7.77% of the total assets of the consolidated financial statements. The equity method net income accounts for 72.85% of the

² In this paper, associates includes both associates and joint ventures.

total net income of the consolidated financial statements. As such, the equity method makes a significant impact on the consolidated financial statements.

11.2. Secondly, the proportion of equity method net income from associates to separate financial statements' net income is 59.26%, which has a significant impact on the separate financial statements as well.

11.3. Finally, prior empirical research showed that the information provided by the equity method is value relevant (e.g. Graham and Lafnowicz, 1996; Kim et al. 2006; Choi et al. 2013). This implies that the information is perceived to be valuable by the market, and actually used by accounting information users in their decision making.

Table 1-1. The Impact of the Equity Method on Financial Statements in Korea ³⁴

	Associates only	Associates and Subsidiaries
Number of investees per investor	5. 93 firms	18. 75 firms
Carrying value of equity-accounted investment on consolidated total assets	7. 77%	18. 7%
Equity method net income on consolidated total net income*	72. 85%	77. 36% ⁵⁶
Equity method net income on parent company's net income in separate financial statements*	59. 26%	113. 42%

* Computed by using absolute values

Importance of the equity method when the equity method is applied to both associates and subsidiaries (assuming that the equity method is applied on the separate financial statements)

12. In addition, in August 2014, the IASB published the narrow amendment to IAS 27 'Separate Financial

³ The sample includes 2011-2012 listed firms who filed the consolidated financial statements in KOSPI stock market of Korea, excluding financial institutions, those whose net assets were less than 0, and those whose fiscal year-end was not December. The result is 746 firms.

⁴ The data was hand-collected from the notes of auditor's reports.

⁵ Equity method net income of associates and subsidiaries = net income that belongs to parent company in the consolidated financial statements – net income in the separate financial statements.

⁶ The reason why the net income of the equity method seems odd is that the equity method net income is not always positive. For example, if we assume that associates' net income is +50, subsidiaries' net income is -90, and parent's net income is 100, the percentages would be calculated as presented in the table below (non-controlling interest is ignored, and absolute value was used for calculating associates' and subsidiaries' net income.).

	Associates only	Associates and Subsidiaries
Equity method net income on consolidated total net income	83. 33% (=50/(100 + 50 – 90))	66. 68% ((100 – 60)/(100 + 50 – 90))
Equity method net income on parent company's net income in separate financial statements	50% (=50/100)	130% (= (50+90)/100)

Statements', allowing the usage of the equity method in the separate financial statements. This amendment implies the extended usage of the equity method accounting.

13. Because application of the equity method is allowed to the separate financial statements and because the equity method is applied to associates as well as subsidiaries, its impact on the financial statements will be even greater.

- 13.1. If the equity method is applied to the 2011-2012's separate financial statements of the listed companies in Korea's KOSPI market, the proportion of the equity method net income to the consolidated total net income would be 77.36%.

- 13.2. In addition, the proportion of the equity method net income to the parent company's net income in the separate financial statements increases to 113.42%. The proportion is 59.26% when considering only associates. 54.16%, which is the difference between the two, is the impact of subsidiaries' equity method net income on the separate financial statements' net income.

- 13.3. These results show that the size of the equity method net income from investees could be greater than that of parent company's net income, if we extend the usage of the equity method to subsidiaries. We might be able to conclude that the impact of the equity method on the separate financial statements is much more than significant.

14. In addition, various additional issues should be considered when applying the equity method to the separate financial statements. The following are some of the examples.

- 14.1. One issue is whether the information provided by the equity method is useful, mainly due to the redundancy (for example, the net income reported in the equity method-applied separate financial statements must be the same as the net income that belongs to the parent company in the consolidated financial statements). Han and Park (2013), who conducted research on Korean companies, reported that the value relevance of consolidated financial statements is statistically indifferent from that of the equity method-applied separate financial statements. Also, Yoo and Cha (2014) reported that the incremental value relevance of the equity method is smaller than that of the cost method when it is applied to the consolidated financial statements. These results suggest that when the equity method is applied to the separate financial statements, the information usefulness may in fact decrease.

- 14.2. The information about the parent company as an entity that has been previously provided by the separate financial statements will no longer be available to the market.

- 14.3. New accounting issues may occur. For example, there can be incidents where the information provided by the equity method on the separate financial statements and the information on the

consolidated financial statements might not match (e. g. because of no recognition of losses in excess of carrying value).

14.4. Lastly, as explained in paragraph 13, the importance of the equity method will significantly increase. This suggests that the vague standards and undefined issues in the current IAS 28 need to be urgently addressed.

14.5. Therefore, allowing the equity method on the separate financial statements should not be lightly regarded as simply allowing another optional accounting method. It could imply much bigger fundamental change.

15. In summary, the effect of the equity method on financial statements is not ignorable. Actually it is significant. The allowance of the equity method in the separate financial statements increases the importance of the equity method to an even higher level. Therefore, amendments in regards to the equity method are urgently required. On top of this, the application of the equity method to the separate financial statements could cause several important issues, which the IASB should take into careful consideration.

THE OBJECTIVES OF THIS REPORT AND THE ISSUES DISCUSSED IN THIS REPORT

16. The objective of this report is to present issues that we believe the IASB should consider in amending IAS 28, the current standard of the equity method, as well as to present possible alternative ways to resolve ongoing issues regarding the equity method. Therefore, this paper focuses on presenting the problems of the current IAS 28 and suggesting interim alternatives. This is described in more detail in the followings.

16.1. Firstly, the history of the equity method has been reviewed in Chapter 2. In addition, we have compared the GAAPs among Germany, the USA and Korea. From the review and the comparison, we were able to find what has been considered as the concept of equity method and on what concept each jurisdiction has based their equity method accounting.

16.2. Secondly, by introducing a new dimension called 'scope of equity-accounted group,' we have introduced 3 alternative concepts of the equity method in Chapter 3. We proposed how accounting standards shall differ for each alternative, and also analyzed why such inconsistencies are still present within the current IAS 28.

16.3. Thirdly, based on experience of Korea, in Chapter 4, we presented additional issues that the IASB should consider when carrying out the equity method research project, including the expected issues from allowing the equity method for the separate financial statements. Ever since 1998, Korea has mandated the application of the equity method on the stand-alone financial statements. Additionally, prior to the adoption of IFRS, the equity method-applied

stand-alone financial statements were deemed as the primary financial statements in Korea. Therefore, Korea has extensive experiences of resolving issues that occurred from applying the equity method to the stand-alone financial statements. There are many cases that are not included in this paper due to the technical and situation specific nature of such cases. However, these cases can be provided to the IASB, if necessary.

16.4. Finally, by using market-based research, in Chapter 5, we have tested whether the equity method-applied separate financial statements provide more valuable information, compared to the cost method. We found that the information users value the information provided by the equity method.

17. We would like to note again that the purpose of this report is not to provide a final version of a new standard on the equity method. Instead, this report intends to assist the further improvement and development of the equity method through deliberations by the constituents.

CHAPTER 2 DEVELOPMENT OF THE EQUITY METHOD ACCOUNTING

18. This chapter consists of two parts. The first part describes the history of the equity method. The history of the equity method enables us to understand why there has been so much confusion on the concept of the equity method. The second part compares several jurisdictions' GAAPs on the equity method. By doing so, we are able to find the differences between their standards on the equity method and to check if their standards are based on a clear concept of the equity method.

HISTORY OF THE EQUITY METHOD AND THE CONCEPT OF THE EQUITY METHOD

19. The concept of the equity method and the reason why its concept is not yet clearly defined can be found by reviewing the history of the equity method. Nobes (2002) summarizes succinctly the history of the equity method.

20. Nobes (2002) states that historically, the concept of the equity method always had divided viewpoints of being seen as a consolidation technique as well as a measurement basis. We reorganize Nobes (2002) for the purpose of this report.

Equity method as consolidation

21. At the beginning, the consolidated financial statements were not well accepted because they include assets and liabilities not directly owned by a reporting entity. However, the consolidated financial statements began to gain wider acceptance after a consensus had been formed on the following two problems of the stand-alone financial statements. One is that parent's stand-alone financial statements do not reflect subsidiaries' losses on a timely manner, and the other is that they do not recognize the subsidiaries' net income, although a parent could take subsidiaries' net income through dividends at any time if it desires.

22. However, since the concept of consolidation was not yet fully developed during the early 20th century, the equity method was used as an alternative to consolidation. It was used as a way of reflecting the performance of subsidiaries on the parent's stand-alone financial statements. As the concept of consolidation was completed in the 1930s, the equity method was gradually replaced by the consolidated financial statements.⁷
23. The equity method was not completely banned from the consolidated financial statements. The equity method was used in the consolidated financial statements as a backup for certain subsidiaries that were not consolidated. In other words, the equity method was applied to unconsolidated subsidiaries, in order to obtain the same effect as being consolidated. For example, APB Opinion 18 (1971) requires the equity method to be applied to the subsidiaries that are not consolidated due to temporary control, control being with non-major owners, large minority interest, and foreign subsidiaries.⁸
24. These two historical facts enable us to conclude that consolidation is a sure contender for the concept of the equity method. One basis for the conclusion is that the equity method was used to incorporate similar effects to the consolidated financial statements as to consolidation. Another basis is that the equity method was applied only to the subsidiaries which are part of a group with the parent, not to the associates. In other words, in order to achieve similar effects as consolidation on financial statements, a simpler method such as equity method was used instead of full consolidation for the subsidiaries that are part of a group. In conclusion, it is clear that at the initial stage, the concept of the equity method was consolidation, for the application of equity method was towards the controlling entities such as subsidiaries (Dickerson, 1933).

Equity method as measurement

25. Even after the full development of consolidation procedures, the equity method has been constantly applied to the parent's stand-alone financial statements in many jurisdictions. Its purpose seems to be bringing similar effect of consolidation on a parent's financial statements.⁹
26. In addition, a new attempt, which is to apply the equity method to investments in certain non-subsidiaries, commenced during the 1960's. It resulted in applying the equity method to non-controlling entities such as the associates, joint ventures or companies in which there is a substantial interest. Its purpose seems clear. Since investees on whom an entity has significant influence should have a distinctly different nature from all other investments, the entity should recognize

⁷ Nobes called this application of the equity method as "proto-consolidation", since the equity method was used before the concept of consolidation was fully established.

⁸ Nobes called this application of the equity method as "substitute-consolidation", because the equity method was used as a substitute of consolidation.

⁹ Nobes called this application of the equity method as "pseudo-consolidation" since the equity method produces similar effects as consolidation on parent's stand-alone financial statements.

more than just the simple receipt of dividends to recognize the performance of the investees. However, the entity does not own enough controlling power to enforce a full consolidation. In other words, the equity method has been viewed as an intermediate form of accounting between the cost method and full consolidation. Still to this day, many jurisdictions continuously use the equity method in their stand-alone financial statements. Until the full adoption of IFRS in 2011, Korea had used the equity method in the stand-alone financial statements as well.

27. Moreover, numerous attempts have been made to apply the equity method to the associates in the consolidated financial statements as well. The current IAS 28 also allows this method to be used for the associates and joint ventures in the consolidated financial statements.
28. The extended application of the equity method to associates had to face much opposition in the beginning. The biggest opposition arose based on the fact that the non-subsidiaries are not part of a group; how can the equity method be applied to non-controlled entities such as associates? According to Nobes, to overcome this opposition, a new concept of the equity method has been introduced such that the equity method is a valuation method rather than a consolidation method. In fact, the Dutch term for the equity method is "Intrinsieke Waarde (Intrinsic Value)". Additionally, since fair value of investments cannot always be reliably measured, the idea of viewing the equity method as an alternative of fair value measurement started to emerge.
29. The historical facts related with the extended usage of the equity method show that the equity method contains the concept of measurement basis. Especially, the consolidation technique, which includes concept of control and group, cannot possibly explain the concept of equity method in its own terms and regulations, if the equity method is to be applied to non-controlled entities.
30. In summary, the application of the equity method to subsidiaries clearly shows that consolidation is a part of the concept of the equity method. However, (1) the application of the equity method to non-subsidiaries in the consolidated financial statements, and (2) the application of the equity method to both subsidiaries and non-subsidiaries in the stand-alone financial statements make it unclear whether the concept on which the equity method is grounded is a consolidation or a measurement basis.
31. Up to this point, this paper has examined the equity method that has been developed through history based on two different concepts – consolidation and measurement. Hereafter, we would like to take a look at Germany, the United States and Korea through history focusing on two different concepts – consolidation and measurement in each respective jurisdiction.

EQUITY METHOD IN GERMAN GAAP, US GAAP AND KOREAN GAAP

Equity method in German GAAP¹⁰

32. German GAAP is defined by German commercial law (Handelsgesetzbuch, hereafter "HGB").
33. In German GAAP, all business enterprises are required to prepare a set of annual financial statements, also known as stand-alone financial statements. Current investment is measured at the lower of cost or market value (not fair value) and non-current investment is accounted for at amortized cost. Impairment is recognized when it is expected not to be temporary. Such accounting treatment resembles the cost method option in accordance with the separate financial statements of IAS 27.
34. German GAAP accounts for the associates using the equity method in the consolidated financial statements only.
35. German GAAP allows two variations of the equity method. In other words, entities may either choose to use *book value method* or *the proportionate equity method* when applying the equity method to associates. Under both of the accounting methods, investor's share of associate's post-acquisition profits or losses and other changes are included in the subsequent measurement. However, the initial recognition of the associate under the two accounting methods is different.
36. *Book value method*¹¹ recognizes the associate at acquisition cost, including goodwill. *Book value method* indicates that any difference between the associate's equity and the cost of acquisition is analyzed to establish the reasons for the difference and is then allocated to the items – such as fair value adjustments (i.e. the difference between the fair value and the carrying value of the associates equity and liabilities) and goodwill.
37. Under *the book value method*, any goodwill arising on the acquisition of the investment is presented as part of the carrying amount of that investment, rather than separately. Consequently *the book value method* is similar in accounting as in IAS 28, since only the investor's share is considered in the

¹⁰ Since 2005, Germany adopted IFRS for the consolidated financial statements of companies whose debt or equity securities trade in a regulated market and companies in the process of being listed on such a market mandatorily. However, IFRS is adopted optionally for unlisted companies and companies listed on public securities markets that are not regulated markets, while separate financial statements of listed and unlisted companies are not permitted the use of IFRS but German GAAP. Since the purpose of this chapter is to examine the viewpoint of the local GAAP equity accounting developed from each jurisdiction; we will look over the equity method accounting of local GAAP (especially, Germany and Korea) before the application of IFRS.

¹¹ Under German GAAP, the book value method is also applied in consolidation, however, the book value method does not correspond to the acquisition accounting under IFRS 3. Under the book value method, any difference between parent's share of the subsidiary's equity and the cost of acquisition is analyzed to establish the reasons for the difference and then allocated to the items of the consolidated balance sheet if it is attributable to positive or negative fair value increments in the subsidiary's stand-alone financial statements. Therefore, the fair value increments may be recognized only up to the extent of the parent's share of the differences, and the cost of the shares attributable to non-controlling interest is ignored.

equity method.

38. Under the *proportionate equity method*, goodwill is presented separately, as the carrying amount of the investment at the acquisition date represents only the proportionate share of equity acquired, not the total purchase price paid. Therefore, this method is also known as two-line consolidation¹².
39. Under German GAAP, the viewpoints regarding the equity method are analyzed as follows:
40. First, the recognition of the initial cost under both *book value method* and *proportionate equity method* is similar with that of IFRS 3— purchase price is allocated to fair value adjustment and goodwill. Also, under both methods, the investor recognizes the investor's share of associate's post-acquisition profits or losses as the investor's profit or loss and changes in equity of the associate as investor's equity. These are the characteristics from the consolidation viewpoint.
41. Second, under German GAAP, the transactions between the investor and the associates may be proportionately or fully eliminated. Since HGB allows full elimination, it seems that the HGB particularly supports the consolidation viewpoint. One more accounting treatment that seems to be in line with the consolidation viewpoint under German GAAP is that the equity method is required to be applied to the subsidiaries that are not consolidated.
42. On the contrary, uniform accounting policy is not required for the associates. Even though it might be for practical conveniences, it is surely a departure from the consolidation viewpoint, but close to the measurement viewpoint.
43. To summarize, under German GAAP, the equity method for the associates is applied only in the consolidated financial statements. The purpose of this is to show the effect of consolidating

¹² Comparison of the initial recognition under German GAAP and IAS 28

Facts	
The book value, the fair value and the acquisition cost of the associate acquired by Company A are as follows:	
Acquisition cost for 30% of the associate	CU 2,000
The book value of the associate's net asset at acquisition date	CU 4,000 (1,200 for 30% interest)
The fair value of the associate's net asset at acquisition date	CU 5,000 (1,500 for 30% interest)

Under the two methods in German GAAP and IAS 28, the associates and the related reserves are presented in the investor's balance sheet as follows:

Book value method	Proportionate interest method	IAS 28
Assets: Associate CU 2,000	Assets: Associate CU 1,500 Equity: Reserves, net of goodwill in associate (CU 500)	Assets: Associate CU 2,000

associates in the consolidated financial statements by presenting profit and loss of associates on which the investor has a lower level of influence than on the subsidiaries. However, as discussed previously, characteristics of measurement that involve not enforcing the uniform accounting policy can be clearly differentiated from the consolidation viewpoint. Therefore, it is reasonable to view German GAAP as having a mixed viewpoint.

Equity method in US GAAP

44. The accounting treatment for associates under US GAAP seems to put more emphasis on measurement than one-line consolidation. When examining specific accounting treatments with the equity method under US GAAP, the concept of measurement can be clearly observed.
45. First of all, under US GAAP, investment in associates can be accounted at fair value like financial assets (i.e. fair value option) or by using the equity method. The fact that the equity method and fair value measurement are optional implies that the equity method can be viewed as a method of measurement. Additionally, the fair value option is permitted for all associates regardless of business type. This clearly differs from accounting under IAS 28, which is restricted to entities such as venture capitals.
46. Second, when an associate applies the equity method, US GAAP does not require the uniform accounting policy between the investor and the associates. Additionally, different reporting dates between the investor and the associates are allowed without any adjustment for the effects of significant events or transactions that occurred during the two reporting dates if the two reporting dates are within 3 months. If this is viewed from the basis of consolidation, it will make much more sense to reflect all the significant events and transactions on the financial statements, because consolidated profit and loss would be most accurately stated after the adjustments. These accounting treatments again illustrate that US GAAP reflects the viewpoint of measurement, which recognizes the associates as the financial assets in nature.
47. Third, under US GAAP, the accounting for financial assets is applied for recognizing impairment of associates. Impairment of associates is generally recognized only if the impairment is other-than-temporary. This accounting treatment implies that an investor views the nature of the associate as a financial asset. If it treats the associate as a certain part of its business (i.e., consolidation viewpoint), the investor may recognize the impairment loss of the associate even when it observes the impairment indicators of the assets of the associate such as the continuous operating loss, the obsolescence of product lines, etc. However under US GAAP, the investor recognizes the impairment loss only when the associate's share price has fallen other-than-temporary. Additionally, the investor does not perform impairment test separately for goodwill or the associate's assets.
48. Lastly, in the case when the investor loses significant influence over associates and therefore equity-accounted investment becomes available-for-sale (AFS) or fair value through profit or loss (FVTPL)

securities, investor's carrying amount on the date of status change becomes the carrying amount of the remaining investment. The reason is that the investments in associates are viewed to have the same attributes as financial assets that fall into the category of AFS or FVTPL securities. Therefore, when the change occurs within the financial assets that have the same attributes, they are not required to be measured at fair value.

49. As we have discussed above, US GAAP's equity method has many characteristics of the measurement approach. However, the consolidation viewpoint is not completely precluded.
50. First, according to US GAAP, when an investor initially acquires the equity method financial instruments, directly attributable transaction cost is recognized as the acquisition cost of investments in the associate. On the date of the acquisition, fair values are determined for the associate, and a difference between the investor's share of the fair values of the acquired net asset and the cost of acquisition is recognized as goodwill. This accounting treatment helps to stimulate the same effect as consolidation on investor's financial statements.
51. Second, unrealized profits or losses from transactions between the investor and the associates are eliminated.
52. To summarize, it is clear that under US GAAP, the equity method is deemed to be a measurement basis in most aspects because the equity method reflects the view that the associate is regarded as one of the categories in financial assets. However, we can see that the consolidation viewpoint is not completely precluded.

Equity method in Korean GAAP

53. The equity method of K-GAAP¹³ discussed in this section is with regard to stand-alone financial statements (not the consolidated financial statements) which were viewed as primary financial statements before Korea adopted IFRS in 2011.
54. In 1998, K-GAAP was amended in order to achieve convergence with global accounting standards. One of the most significant amendments was that the equity method of accounting treatment was required to be applied on the stand-alone financial statements for associates as well as subsidiaries. This was the time when the consolidated financial statements were not required for all companies. Thus, the equity method was introduced to the stand-alone financial statements for all companies as a substitute for consolidation. Based on that, K-GAAP's equity method could be considered as a substitute for consolidation, and various equity method related issues could be interpreted in the

¹³ Since the adoption of IFRS in 2011, unlisted companies were given an option to choose either IFRS or the new K-GAAP. The new K-GAAP is a result of the amendment of old K-GAAP to incorporate key concepts of IFRS while simplifying the old K-GAAP so as to place less burden on unlisted companies. In this section of the report, we look over the equity method of old K-GAAP that has been used before the adoption of IFRS.

viewpoint of consolidation. The concept of the consolidation viewpoint in K-GAAP is summarized as follows:

55. The most distinctive characteristic can be found in the equity method for subsidiaries, which is designed to reflect the same effect as consolidation on the stand-alone financial statements. Under K-GAAP, the equity method for subsidiaries¹⁴ is defined as an accounting treatment that aligns profit or loss and net asset in the stand-alone financial statements with parent's share of profit or loss and net asset in the consolidated financial statements, except when the losses of subsidiaries exceed their carrying value.
56. There were even discussions in Korea that when the book value of the equity accounted subsidiary is below zero, the investor shall recognize the investment in the subsidiary as a liability which is consistent with the result of consolidation.
57. Secondly, the transactions between the investor and the associates are recognized in the investor's financial statements only to the extent of unrelated investors' interest in the associates. Therefore, unrealized profits or losses from transactions with associates are eliminated only to the extent of the investor's ownership interest which has the same effect as consolidation.
58. Third, in recognizing the impairment loss for associates, if the impairment is related to goodwill, then the reversal of the impairment is not permitted. It means that the associate is not regarded as one financial asset, but is assumed to be consisted of underlying assets of associate, fair value adjustment and goodwill.
59. Lastly, it is required that the uniform accounting treatment with the investor be applied for associates.
60. Though the equity method in K-GAAP incorporates such a strong consolidation viewpoint, the measurement basis viewpoint of the equity method has not been completely precluded.
61. First, under K-GAAP, when significant influence is lost by partial disposal of associate's shares or other reasons and is classified as AFS or FVTPL securities, the carrying value of the remaining investments is measured at the carrying value of the associate before the disposal. This is the same accounting treatment as in US GAAP, which represents the measurement viewpoint that the investment in an associate has the same nature as a financial asset.
62. Second, the impairment indicator of the associates under K-GAAP refers to the impairment indicators of financial assets. In other words, an investor has the view that the nature of the

¹⁴ The equity method for subsidiaries has numerous implications that need to be considered on the ED of IAS 27 that was announced in December 2013 by the IASB. The equity method for subsidiaries will be discussed in more detail in Chapter 4.

associate is not a part of an investee's business but a financial asset. It also represents the measurement viewpoint.

63. To conclude, the equity method has been developed in K-GAAP as a substitute for consolidation, i.e. one-line consolidation, therefore, we can easily find numerous aspects of consolidation basis in the equity method of K-GAAP. However, the measurement basis is not completely precluded.

Conclusion

64. As explained above, the equity method has developed very distinctly in Germany, the United States and Korea. In the case of Germany and Korea, the equity method was applied as a substitute for consolidation. Especially, Korea has a strong viewpoint regarding the equity method as a substitute of consolidation and accounts for not only the associates but also subsidiaries with the equity method on the stand-alone financial statements. However, it should be noted that the characteristics of measurement basis were not completely precluded. In the case of US GAAP, the fact that the fair value option is allowed implies that the equity method is considered as a measurement basis; however, even US GAAP also does not completely exclude the consolidation basis by applying the same consolidation techniques such as acquisition method on the subsidiaries at initial acquisition.
65. Consequently, it should be noted that the concept of equity method which has been developed in each jurisdiction is not exclusively on a consolidation basis or a measurement basis.

CHAPTER 3 PROPOSAL OF POSSIBLE CONCEPTS OF THE EQUITY METHOD AND THEIR APPLICATIONS

A NEW DIMENSION: SCOPE OF EQUITY-ACCOUNTED GROUP

66. Many different countries' accounting standards that deal with the equity method, including IAS 28 (2011), are being evaluated as having a mixture of characteristics that indicate the equity method as a one-line consolidation and the measurement basis. Although these two underlying concepts of the equity method are mixed in the standards for the equity method, these are seemingly unrelated concepts. We believe that the lack of dimension differentiating the two different concepts of the equity method has created the mixtures of the concepts giving rise to internally inconsistent standards for the equity method.
67. Without a dimension that regulates different concepts of the equity method, internally inconsistent standards having mixture of the different concepts will continue to exist, similar to the current accounting standards for the equity method. In this report, we have made efforts to create alternative equity method accountings that are more internally consistent. For this purpose, we propose the new dimension, "*scope of equity-accounted group*," to define the underlying concepts of the equity method.
68. Equity-accounted group¹⁵ is '*a single economic entity*' consisting of an investor and its associate. Scope of equity-accounted group is determined by the extent of inclusion of the associates in the investor's equity-accounted group. Equity-accounted group may include the associate as a whole, a part of the associates, or none of the associates. Scope of equity-accounted group can be seen as one of the dimensions that could possibly explain the concept of the equity method, and this dimension defines the concept of the equity method based on the relationship between the investor and its associate-i.e., whether or not the associate forms the investor's equity-accounted group. With this new dimension, we could bring the old concepts of the equity method – one-line consolidation and measurement basis – into one continuum, and still devise a new concept of the equity method whereby we could develop an internally consistent concept of the equity method. We establish three concepts of the equity method including a concept existing in the middle of the continuum in the following section.

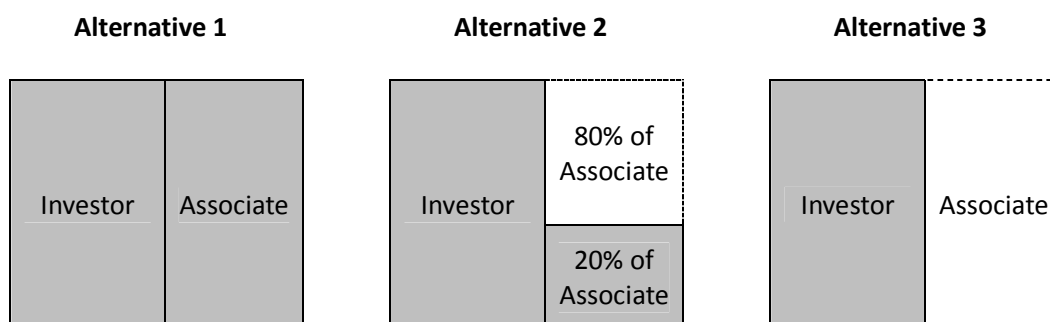
THREE ALTERNATIVES BASED ON THE NEW DIMENSION

69. This report shows that depending on how to define the scope of equity-accounted group, the concept of equity method and the corresponding accounting treatment may vary. We created three

¹⁵ The term 'equity-accounted group' is similar to the term 'group' under IFRS 10, which consists of a parent and its subsidiary. Both terms define the extent of entities that constitute a single economic entity. While 'group' under IFRS 10 is a set of entities which is treated as a single economic entity in consolidated financial statements, 'equity-accounted group' is a set of entities which is treated as a single economic entity in investor's financial statement by means of equity method. In the comment letter, EFRAG proposes to use a term, 'boundaries of economic activities,' instead of the scope of equity-accounted group (please see Appendix 2 and 3).

alternatives depending on the extent of inclusion of investee in the investor's equity-accounted group. The schematic view of the associate's assets and liabilities that are included in the equity-accounted group (the shaded part of the diagram) under the three alternatives are presented in Table 3-1. It is assumed that investor's share is 20%.

Table 3-1. The Schematic View of Three Alternatives



70. Under all three alternatives the associate is presented in one line as equity-accounted investment in investor's financial statements. However, depending on the difference in the scope of equity-accounted group, the accounting treatments and the results may differ.
71. Alternative 1 is a concept that considers the associates as a part of an equity-accounted group, therefore, all of the associates' assets and liabilities are assumed to be owned by the investor. Alternative 2 is a concept that considers only the investor's share of associates as a part of an equity-accounted group, so only a part of the invested amount of associates' assets and liabilities are assumed to be owned by the investor. In contrast, Alternative 3 is a concept that does not consider the associates as part of an equity-accounted group, so the investor does not recognize the assets and liabilities of the associates as its own.

There might be a confusion that Alternative 3 represents fair value accounting for the investment. However, the accounting under Alternative 3 is still the equity method under which changes in net asset of the associate are adjusted to the carrying value of equity-accounted investment.

72. Alternative 1 is a concept close to the equity method as one-line consolidation, and Alternative 3 is close to the equity method as a measurement basis. The new dimension, scope of equity-accounted group has established the continuum of the concepts of the equity method from the equity method as one-line consolidation to the equity method as a measurement basis. In addition, the dimension of 'scope of equity-accounted group' creates Alternative 2 that is an entirely different concept from the other two alternatives. Although Alternative 2 is somewhat similar to the current IAS 28, this is an internally consistent concept unlike the current accounting standards for the equity method.

CONCEPTS OF THE EQUITY METHOD UNDER THE NEW DIMENSION

Alternative 1

73. Alternative 1 is a method where associates are accounted for by presuming that the associates are part of the equity-accounted group. The concept of a single economic entity is applied not only to subsidiaries, but also extended to associates. When consolidating the subsidiaries, the consolidated net income/net asset are added together by viewing the parent company and the subsidiaries as one single economic entity, and, within the consolidated net income/net asset, the portion attributable to the owners of the parent company is distinguished from what is attributable to the non-controlling interest-i.e., NCI. By using the same concept of consolidation, amounts of associate's net profit and net asset attributable to the investor are determined. When the associate's net asset changes, the change could be attributable to the investor and the other owners of the associate. The change of the investor's equity-accounted investment would be that amount attributable to the investor.

74. This alternative can be defined as:

"The investment is accounted for as one-line in the financial statements for the same amount as the net asset value attributable to the investor when an associate is consolidated."

Alternative 2

75. Alternative 2 is a method that narrows down the scope of equity-accounted group to the investor's share in the associates. In other words, associates are included in the scope of equity-accounted group, similar to Alternative 1. However, not 100% of the associates is included in the scope of equity-accounted group, but only the investor's share based on the investor's ownership of the associates is included. This is a method of accounting in which only the investor's share of the associate's assets, liabilities, and performance results is accounted for. This alternative coincides with the concept indicated in Paragraph 11 of the current IAS 28 (2011). The second half of that paragraph states the following: 'Because the investor has joint control of, or significant influence over, the investee, the investor has an interest in the associate's or joint venture's performance and, as a result, the return on its investment. **The investor accounts for this interest by extending the scope of its financial statements to include its share of the profit or loss of such an investee.**'

76. This alternative can be defined as:

"The investment is accounted for as one-line in the financial statements for the same amount as the net asset value attributable to the investor when only the investor's share of an associate is consolidated."

Alternative 3

77. Alternative 3 confines the scope of equity-accounted group only to an investor. Thus, it is a concept where associates are not seen as part of an equity-accounted group.
78. The equity-accounted investments could be viewed as one of the financial asset categories. Traditionally, cost method and fair value method have been regarded as measurement basis for financial assets. However, under this alternative, the equity method is another measurement basis for financial asset. As opposed to the amortized cost or fair value of financial instruments that are measured in accordance with IAS39/IFRS9, the equity method would measure the value of the investment based on the net asset of the associates.
79. This alternative can be defined as below:
- “The investment is accounted for as one-line in the financial statements by measuring the value of the investment based on the net asset of an associate, assuming the associate is not a part of an equity-accounted group.”
80. The alternatives are summarized as follows.

Table 3-2. The Summary of the Alternatives

	Alternative 1	Alternative 2	Alternative 3
Definition	The investment is accounted for as one-line in the financial statements for the same amount as the net asset value attributable to the investor when an associate is consolidated.	The investment is accounted for as one-line in the financial statements for the same amount as the net asset value attributable to the investor when only the investor's share of an associate is consolidated.	The investment is accounted for as one-line in the financial statements by measuring the value of the investment based on the net asset of an associate, assuming an associate is not a part of an equity-accounted group.
Scope of equity-accounted group	Investor and the associates	Investor and its share of the associates	Investor only
Nature of investment	Business	A part of business	Financial asset

81. Applying each alternative to the transaction with the associates will help understanding of the alternatives. In the following example, the investor owns 20% of an associate and the investor sold

land to the associate with a gain of CU (currency unit) 100 upon disposal of the land.

81.1. For Alternative 1, since the investor and the investee are considered as part of one equity-accounted group, the transaction between the two entities needs to be adjusted so that the investor's financial statements do not reflect any effect of the transaction. Therefore the impact of the transaction is eliminated in full. In other words, the profit of CU 100 from disposal should be eliminated.

81.2. For Alternative 2, 80% of the transaction is considered to be a transaction outside the equity-accounted group and the remaining 20% is considered to be a transaction within the equity-accounted group. Therefore, adjustments need to be made in the investor's financial statements to exclude the 20% of the transaction. In other words, out of the disposal gain of CU 100, only CU 20 is considered to be profit/loss arising from the internal transaction, and therefore only the profit of CU 20 should be eliminated.

81.3. For alternative 3, since an associate is not considered as part of an equity-accounted group, no adjustment to eliminate the impact of the transaction between the two entities is necessary.

APPLICATION OF THE ALTERNATIVES

82. In the preceding paragraphs, we have defined the three alternatives. Now we present how each alternative of the equity method applies to the transactions that typically occur in relation to holdings of investment in an associate. Table 3-3 is a summary followed by a detailed analysis.

Table 3-3. The Application of the Alternatives

	Alternative 1	Alternative 2	Alternative 3
Allocation of consideration transferred in initial recognition of the investment	IFRS 3 applies	IFRS 3 applies	IFRS 3 does <u>not</u> apply, i.e., allocation is not required
Recognition of changes in net asset of the associate	Recognized consistently with the associate's accounting	Recognized consistently with the associate's accounting	Recognized <u>in profit or loss (or other comprehensive income)</u> depending on the type of financial instrument
Recognition of other capital transactions of the associate	Recognized <u>in equity</u>	Recognized <u>in profit or loss</u>	Recognized <u>in profit or loss (or other comprehensive income)</u> depending on the type of

Uniform accounting policies	Required	Required	financial instrument <u>Not</u> required
Losses of associates in excess of their carrying value	Further loss recognition <u>not</u> ceased	Further loss recognition <u>not</u> ceased	Further loss recognition <u>ceased</u>
Transaction with associates	<u>Fully</u> eliminated	<u>Only investor's share</u> is eliminated	<u>Not</u> eliminated
Impairment of the investment	Impairment at <u>associate's assets level</u>	Impairment at <u>associate's assets level</u>	Impairment at <u>the investment level</u>
Consideration of assets held by the associate	Treated as if held <u>by investor</u>	Treated as if held <u>by investor (to the extent of the investor's share)</u>	Treated as financial instruments outside the equity-accounted group
Additional acquisition without status change	Equity transaction	Non-equity transaction (initial recognition)	Non-equity transaction (initial recognition)
Additional acquisition with status change from associate to a subsidiary	IFRS 3 does <u>not</u> apply, i.e., regarded merely as change in percentage of ownership	IFRS 3 applies	IFRS 3 applies

Initial recognition of the investment

Alternative 1 & 2

83. Under Alternative 1 and 2, IFRS 3 should be applied to the acquisition of the investment. This is because the acquisition of investment represents acquisition of a business (under Alternative 1) or the investor's share of a business (under Alternative 2).

83.1. As IFRS 3 is applied, the transaction costs for acquiring the equity-accounted investment are expensed. Also, similar to a business combination to which IFRS 3 is applied, the consideration transferred is allocated to the identifiable assets and liabilities of the associates.

83.2. At this point, identifiable assets and liabilities are measured at fair value; and

83.3. The difference between the consideration transferred and the fair value of identifiable assets and liabilities is allocated to goodwill (or gain on bargain purchase).

Alternative 3

84. IFRS 3 is not applied. Instead, the acquisition should be treated as an acquisition of an individual financial asset rather than a business or a share of a business. However, what measurement basis should be used for the determination of the initial acquisition cost of the investment to associates under Alternative 3 needs more consideration, which is described below.

85. In the initial recognition of the equity accounted investment, the following three measuring bases may serve as possible alternatives.

85.1. Fair Value

This is the same approach that the current IAS 39 has adopted. Under IAS 39, a financial asset is measured at fair value plus directly attributable transaction cost, unless the instrument is classified as at fair value through profit or loss.

85.2. Acquisition cost

This is an approach that the current IAS 28 (2011) has adopted. This method measures the equity accounted investments at acquisition cost.

85.3. The carrying value of net asset

As Alternative 3 measures the value of the investment based on the net asset of an associate, carrying value of net asset of the associate in the associate's financial statements may serve as an alternative for the measurement upon initial recognition. In this case, the difference between the consideration transferred and carrying value of associate's net asset may occur and the accounting treatment for the difference should be considered.

86. Acquisition cost may not be equal to the fair value of the investment. For example, marketable equity instruments could be acquired outside the market at a consideration not equal to market value or free of charge. Also, the carrying value of net asset of an associate is generally different from the fair value of the investment. Therefore, depending on which measurement basis is used, the initial value of the investment could be different from its fair value. The question is whether it is appropriate to measure the investment at the value that is not equal to the fair value.

87. Equity accounted investment is generally held for exercising significant influence over the associate whereas fair value accounted financial instruments such as financial instruments classified as fair value through profit or loss or available for sale are not. Given the different purposes of holdings between the equity accounted investment and those financial instruments to which IAS 39 is applied, the subsequent difference in measurement for these investments may be justified; however, questions arise concerning the justification of the difference in the initial measurement for other similar financial assets. We would like to emphasize that it is necessary for the IASB to

take this into consideration.

Comparison to IAS 28 (2011)

88. Under IAS 28 (2011), transaction cost is capitalized and the consideration transferred including the transaction costs is allocated to identifiable assets and liabilities of the associate which results in part of the consideration transferred being allocated to goodwill or gain on bargain purchase. The current IAS 28 contains all components of the three alternative concepts regarding the initial recognition of the investment. The fact that the transaction cost is not recognized as expense is the same as Alternative 3. However, the fact that consideration transferred is allocated to the identifiable assets and liabilities of the associate by applying IFRS 3 and the way that goodwill is calculated are consistent with Alternative 1 and 2.

Recognition of changes in net asset of the associate

89. When net asset of the associate changes, under all three alternatives, the carrying value of the equity-accounted investments is adjusted accordingly. The corresponding account, however, is determined differently depending on which alternative is applied.

Alternative 1

90. Alternative 1 is a method which considers associates as part of the equity-accounted group, and therefore changes in net asset of the associate are reflected in the equity accounted investment as if assets and liabilities of the associate are held directly by the investor. As a result the corresponding account would be determined by the accounting treatment of associate's underlying transactions, which is the cause for the change in associate's net asset. That is to say, if the net asset change of the associate is related to the associate's net profit, the corresponding account should be the investor's net profit. Similarly the net asset change related to the associate's OCI should be reflected on the investor's OCI.

Alternative 2

91. Under Alternative 2, like Alternative 1, the corresponding account would be determined by the associate's underlying transactions because the investor's share of associate's assets and liabilities are regarded as being held directly by the investor. There is no difference in corresponding accounts between the two alternatives. Under both alternatives, associate's assets and liabilities are considered to be held directly by the investor, although it is only a portion of them under Alternative 2.

Alternative 3

92. Under Alternative 3, the equity method would measure the value of the investment based on the

net asset of an associate. However, the associate does not form a part of the investor's equity-accounted group and associate's assets and liabilities are not considered to be held directly by the investor. Therefore, there is no reason to argue that the corresponding account should be determined following the associate's underlying transaction that triggers the changes in net asset of the associate.

93. As an alternative accounting treatment, the corresponding account could be determined based on the type of the investment itself according to IAS 39. We observe that IAS 39 already regulates whether profit or OCI is recognized and we believe that the IASB could develop the basis for where to recognize the change of equity accounted investment consistently with this standard. According to IAS 39, in subsequent measurement, measurement basis and where to recognize the resulting changes of carrying value of the financial asset are determined by the type of financial assets. For example, financial assets carried at fair value through profit or loss are measured at fair value with changes in fair value included in profit or loss, or for available-for-sale financial assets, in OCI.
94. We have not proposed whether profit or OCI is more appropriate. We believe that the issue should be taken into account by the IASB considering the nature of the equity accounted investment.

Example 3.1

Facts

An investor holds a 20% share of an associate. The associate has made a profit of CU 1,000 in the current period, and its net asset has increased by the same amount.

95. Under Alternative 1, the increase in the associate's net asset of CU 1,000 is regarded as the increase in the net asset of the equity-accounted group. However, in the hypothetical consolidated financial statements, CU 800 is attributable to non-controlling interests, and the remaining amount of CU 200 is attributable to the investor. Therefore, the balance of the equity-accounted investments is increased by CU 200 and the same amount is recognized as profit.
96. Under Alternative 2, the investor regards its share of the associate's assets and liabilities as being included on one-line in its financial statements. Among the increase of CU 1,000 in the associate's net asset, the portion that is assumed to be increased on investor's financial statements is the investor's share amount of CU 200 ($CU\ 1,000 \times 20\%$). Applying the same logic, in the income statement, the amount attributable to the investor (CU 200) is recognized as the investor's profit. Thus, the equity-accounted investment increases by CU 200 and the same amount is recognized as profit.
97. As shown in the above paragraphs, there is no difference in the increase to the balance of the equity-accounted investment between Alternative 1 and Alternative 2. However, there are differences in the increase of the net asset and the calculation of the amount attributable to the

investor, which illustrate the distinction of the concepts between the two alternatives.

- Under Alternative 1, the equity-accounted group's net asset increases by CU 1,000 resulting in an increase in the investor's share of it by CU 200.
- Under Alternative 2, both the equity-accounted group's net asset and investor's share increase by CU 200.

98. Under Alternative 3, the equity-accounted investment is measured based on the net asset of an associate. Although assets and liabilities of the associate are not regarded as being held by the investor, the investment is measured at the investor's share amount of the associate's net asset. Therefore, the investor's share amount of CU 200 ($CU\ 1,000 \times 20\%$) is reflected in measuring the investment.
99. However, differently from Alternative 1 or 2, the increase of the equity accounted investment is not necessarily recognized as profit. The corresponding account would be determined independently from the underlying transaction that triggers the increase of the net asset because the transaction is not the investor's transaction. As previously mentioned, the corresponding account should be determined based on the type of the investment itself rather than the underlying transaction of the associate.

Example 3.2

Facts
An investor holds a 20% share of an associate and the associate has revalued its land resulting in other comprehensive income (OCI) of CU 1,000 increased in the current period.

100. This example is a variation of Example 3.1; the increase in the net asset of the associate is recognized as OCI rather than profit.

101. The results under Alternatives 1 and 2 are the same because the investor considers the associate as being entirely or partially included in the scope of equity-accounted group, i.e. equity-accounted investment increases by CU 200 with the same amount recorded in OCI.

102. Under Alternative 3, equity-accounted investment increases by CU 200 as well. But differently from Alternative 1 or 2, the increase of the equity accounted investment is not necessarily recognized as OCI. As explained in Example 3.1, the corresponding account would be determined based on the type of the financial assets rather than the underlying transaction of the associate.

Comparison to IAS 28 (2011)

103. Under IAS 28 (2011), when an associate's net asset increases, the equity-accounted investment is

increased by the investor's share of the increase in the associate's net asset. The increase related to the associate's net profit should be reflected on the investor's net profit and the increase related to the associate's OCI should be reflected in the investor's OCI. Thus, Alternatives 1 and 2 are consistent with IAS 28 (2011).

Recognition of other capital transactions of the associate

104. Change in associate's net asset may occur as a result of the associate's capital transactions in addition to reporting profit/loss or increase/decrease in other comprehensive income.¹⁶ When the net asset of the associate changes due to the associate's capital transactions, different consideration is required as these transactions might be a transaction with an owner of the equity-accounted group or non-owner of the equity-accounted group depending on the scope of equity-accounted group defined in each alternative.

Example 3.3

Facts

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 by increasing share capital because it sees X acting in its capacity as a shareholder. It is assumed that the investor's ownership interest after the capital contribution remains the same at 20%.

Alternative 1

105. Under Alternative 1, the associate and the investor are considered to be one equity-accounted group. Therefore, shareholder X is regarded as an owner of the equity-accounted group, and the transaction is a capital transaction with the owner of the equity-accounted group. As a result of the transaction, equity-accounted investment increases by CU 200 and equity increases by the same amount.

Alternative 2

106. Under Alternative 2, since only the investor's share of the associate is included in the scope of the equity-accounted group, the remaining 80 percent of the shares of the associate is out of the equity-accounted group. Shareholder X, one of the shareholders who own 80 percent of the shares, is not considered to be an owner of the investor's equity-accounted group. Among the increase of CU 1,000 in the associate's net asset, the investor's share of CU 200 is assumed to be a contribution to

¹⁶ These transactions are dealt with in *Exposure Draft ED/2012/3 Equity Method: Share of Other Net Asset Changes*, which was issued in November 2012. Although the IASB decided not to proceed with the ED any more in May 2014, this ED is still relevant in understanding the IASB's current thinking on this issue.

the investor's equity-accounted group from X who is not an owner of the equity-accounted group. As a result, unlike to Alternative 1, this transaction is not viewed as a capital transaction between the owners of the equity-accounted group. Instead, under this alternative, the increase of the equity-accounted investment of CU 200 is accounted for in profit rather than in equity.

Alternative 3

107. The investor does not need to consider whether the asset is gained from its shareholders or third parties. Thus, equity-accounted investment is increased by CU 200.

108. But the issue of the corresponding account should be addressed by the IASB as we previously mentioned in the preceding section of 'Recognition of changes in net asset of the associate'. As in Example 3.1 and Example 3.2, the investor does not necessarily follow the same accounting treatment as the associate's.

109. Following is the application of the three alternatives to issuance of shares to a third party, which is a more common capital transaction.

Example 3.4

Facts

An associate has issued additional 5% of its shares to a 3rd party X for cash of CU 1,000. The associate's net asset before issuing the shares is CU 10,000. As a result of the transaction, net asset of the associate becomes CU 11,000 (CU 10,000 plus CU 1,000), and the investor's ownership interest decreases from 25% to 20%. The investor's share of the associate's net asset decreases from CU 2,500 (CU 10,000*25%) to CU 2,200 (CU 11,000*20%) due to the transaction.

110. This transaction can be seen as if the following barter transactions have occurred, resulting in a decrease of the investor's share of net asset by CU 300.

- The investor transfers 5% of share of the associate's net asset to X (CU 500= CU 10,000×5%).
- The investor receives 20% of the increased in net asset from X (CU 200= CU 1,000×20%).

Alternative 1

111. Under Alternative 1, since the associate and the investor form one equity-accounted group, X becomes one of the owners of the equity-accounted group by obtaining shares of the associate. Therefore, the barter transactions between the investor and X are interpreted as capital transactions between owners of the equity-accounted group. As a result of the transaction, the equity-accounted investment decreases by CU 300 and the same amount is recognized as capital decrease.

Alternative 2

112. Under Alternative 2, with the same logic explained in Example 3.3, only the investor's share of the associate is included in the equity-accounted group, and the remaining 80 percent share of the associate is not. Thus, entity X, one of the shareholders who own 80 percent of shares is not an owner of the investor's equity-accounted group. Thus, unlike to Alternative 1, this transaction is not viewed as a capital transaction for the investor's equity-accounted group. As a result, under this alternative, the decrease of the equity-accounted investment of CU 300 is accounted for in profit rather than in equity.

Alternative 3

113. Under Alternative 3, the equity-accounted investment is measured based on the net asset of an associate. As explained in Example 3.3, the investor does not need to consider whether the increases in net asset is obtained from its shareholders or not. Thus, equity-accounted investment is decreased by CU 300. With regard to the corresponding account, the issue should be addressed by the IASB.

Comparison to IAS 28 (2011)

114. IAS 28 (2011) does not provide clear guidance on how to handle this type of transactions.

ED/2012/3 Equity Method: Share of Other Net Asset Changes requires that changes in an associate's net asset arising from the associate's capital transactions should be recognized in equity. This requirement is consistent with Alternative 1.

Uniform accounting policies

Alternative 1 & 2

115. Since Alternative 1 and 2 consider the associate as being entirely or partially included in the scope of equity-accounted group, uniform accounting policies for the investor and its associates are necessary.

Alternative 3

116. Since the associates are not included in the scope of equity-accounted group under Alternative 3, uniform accounting policies for the investor and its associates are not necessary. Therefore the carrying value of net asset of the associate, which is measured using the associate's own accounting policies, does not need to be adjusted.

Comparison to IAS 28 (2011)

117. Under IAS 28 (2011), uniform accounting policies are required between an investor and its associates. Therefore, IAS 28 (2011) has characteristics of both Alternative 1 and 2 regarding uniform accounting policies.

Losses of associates in excess of their carrying value

Alternative 1 & 2

118. If an associate is considered to be a part of an equity-accounted group, the investor should recognize the associate's losses even if they exceed the carrying value of the investment as in the case of consolidation.

119. As the carrying value of the equity-accounted investment has become '0', the losses in excess of the carrying value cannot be recognized by adjusting the carrying value of the investment. The only way to recognize the losses would be to recognize a liability. However, the concern may arise regarding whether this liability meets the definition of a liability as stated in the Conceptual Framework.

Alternative 3

120. Under Alternative 3, associates are not part of an equity-accounted group and the equity method is one of the measurement bases for a financial asset. Therefore, it is necessary to cease the application of the equity method after the carrying amount becomes '0'. Assets cannot be below zero by definition and the investor has no obligation to assume the liability of the associate.

Comparison to IAS 28 (2011)

121. Under IAS 28 (2011), if the investor does not have the responsibility to recoup the losses, the application of the equity method should be ceased once the carrying amount becomes '0', which is consistent with Alternative 3.

Transaction with associates

Alternative 1

122. Under Alternative 1, since the investor and the investee are considered as part of one equity-accounted group, the transaction between the two entities needs to be adjusted so that the investor's financial statements do not reflect any effect of the transaction. In other words, the profit and loss that occurred to the investor from a downstream transaction is eliminated and the profit and loss that occurred to associate from an upstream transaction is also eliminated in calculating the investor's share of the profit of the associate.

Alternative 2

123. Under Alternative 2, when the transaction between associate and the investor occurs, the investor's share of the transaction is considered to be a transaction within an equity-accounted group. Therefore, adjustments need to be made in the investor's financial statements to exclude the investor's share of the transaction. As a result, among the effects of transaction between the investor and the associate, the portion of an internal transaction within an equity-accounted group should be eliminated through the equity method.

Alternative 3

124. Under Alternative 3, since an associate is not considered as part of an equity-accounted group, the transaction between the investor and its associate is not an internal transaction that requires elimination. Therefore, the effects of the transaction should not be eliminated.

Illustrative examples of transactions with the associate

Example 3.5

Facts

An investor holding a 20% share 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.

125. The inventory sale is accounted for in the investor's and the associate's financial statements as below:

Investor's financial statements		Associate's financial statements	
DEBIT	CREDIT	DEBIT	CREDIT
Account receivable 1,000	Sales 1,000	Inventories 1,000	Accounts payable 1,000
Cost of sales 500	Inventories 500		

126. Under Alternative 1, the entire effects of the transaction between the investor and the associate are eliminated by using the following entry. As a result, the investor does not recognize any profit or loss from the transaction with the associate.

DEBIT	CREDIT
Sales 1,000	Equity-accounted investment 500
	Cost of sales 500

127. Under Alternative 2, since only 20% of the transaction is a transaction within the equity-accounted group, 20% of the effects from the transaction is eliminated by using the following entry. As a result, the investor recognizes 80% of the profit and loss from the transaction.

DEBIT		CREDIT	
Sales	200	Equity-accounted investment	100
		Cost of sales	100

128. Under Alternative 3, the effect of the transaction is not eliminated. Thus, profit of CU 500 from the transaction is recognized in the investor's financial statements.

Example 3.6

Facts

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

129. The purchase of inventory is accounted for in the investor's and the associate's financial statements as below.

Investor's financial statements		Associate's financial statements	
DEBIT	CREDIT	DEBIT	CREDIT
Inventories 1,000	Accounts payable 1,000	Account receivable 1,000	Sales 1,000
		Cost of sales 500	Inventories 500

130. Under Alternative 1, the effect of the transaction between the investor and the associate is entirely eliminated by using the following entry. As a result, the investor does not recognize any profit or loss from the transaction, which is recognized by the associate.

DEBIT		CREDIT	
Equity method net income	100	Equity-accounted investment	100

131. Under Alternative 2, since only 20% of the transaction is a transaction within an equity-accounted group, transaction that needs to be eliminated is not the whole transaction but is limited to 20% of the total transaction. 20% of the effects from the transaction is eliminated by using the following entry. As a result, the investor does not recognize any profit or loss from the transaction, which is

recognized by the associate. This is the same result as Alternative 1, because only 20% of the profit from the transaction is recognized by picking up the associate's profit and then the same amount is eliminated.

DEBIT		CREDIT	
Equity method net income	100	Equity-accounted investment	100

132. Since the transaction effect is not eliminated under Alternative 3, the increase in investor's share in the net asset of the associate, which is resulted from the CU 500 in profits recognized by the associate regarding the upstream inventory sale, is recognized in the investor's financial statements.

133. In Appendix 1, additional issues related to transactions with an associate are discussed, such as the type of transactions to be eliminated, accounts to be adjusted, etc.

Comparison to IAS 28 (2011)

134. Under IAS 28 (2011), consistent with Alternative 2, only the investor's share amount of the transaction between the investor and its associate is eliminated.

Impairment of the investment

Alternative 1 & 2

135. Under Alternative 1 and 2, since the associate is considered, full or in part, to be a part of an equity-accounted group, the investor applies impairment accounting for the associate's assets and liabilities in the same way as the investor's own assets and liabilities. Therefore, the impairment accounting will be applied as follows:

135.1. Indicators of the impairment should be those for non-financial assets provided in IAS 36. This is because the equity-accounted investment is not a financial asset but a collection of assets and liabilities that the associate holds.

135.2. Consideration for cash generating units (CGU) is needed for the assets and liabilities of the associate.

135.3. Fair value adjustments that are included in the carrying value of the equity-accounted investment are adjusted to the carrying value of the related assets and liabilities when they are compared with their recoverable amounts.

135.4. Goodwill that is included in the carrying value of the equity accounted investment is also subject to the impairment test.

135.5. Those impairment accounting treatments would lead to the impairment losses being allocated to individual assets of the associate.

135.6. Reversal of impairment loss is required.

Alternative 2

136. Alternative 2 is different from Alternative 1 in that only the portion of the assets and liabilities is treated as being held by the investor. However, it would not make any difference in the impairment test between the two alternatives. This is because under Alternative 2, the portion of carrying value of an asset of the associate would be compared with the same portion of recoverable amount of the asset, while under Alternative 1, the whole carrying value of the asset is compared with the whole recoverable amount of the asset.

Alternative 3

137. In contrast, under Alternative 3, the associate is not a part of an equity-accounted group and the equity-accounted investment is regarded as a financial asset. Therefore, the impairment accounting will be applied as follows:

137.1. Indicators of the impairment should be those provided in IAS 39, because the equity-accounted investment is a financial asset. Therefore, the impairment indicators for financial assets should be applied.

137.2. The impairment test is performed at a level of the equity-accounted investment. Therefore, the impairment of individual assets does not need to be considered and impairment loss of the equity-accounted investments is not allocated to the individual assets of the associate.

137.3. Reversal of impairment losses is prohibited in consistence with IAS 39.

Comparison to IAS 28 (2011)

138. Under IAS 28 (2011), the need for impairment test is decided by applying the indicators of IAS 39. IAS 28 (2011) BCZ45¹⁷ prohibits allocating impairment loss to associate's individual assets. This is consistent with Alternative 3. However, in the case where an associate recognizes the impairment

¹⁷ BCZ 45 of IAS 28 (2011)

In its redeliberations, the Board affirmed its previous decision, but in response to the comments made, decided to clarify the reasons for the amendments. The Board decided that an entity should not allocate an impairment loss to any asset that forms part of the carrying amount of the investment in the associates or joint venture because the investment is the only asset that the entity controls and recognizes.

loss, paragraph 32 of IAS 28 (2011)¹⁸ states that an investor's share of the associate's profit or loss after acquisition shall be calculated based on their fair values at the acquisition date. This requirement is consistent with Alternative 1 and 2.

Considerations of assets held by the associate

139. Depending on whether the associate is a part of an equity-accounted group or not, different considerations are required for the asset held by the associate. If the associate or a portion of the associate is part of an equity-accounted group with an investor, the investor is considered to directly hold all or a portion of the associate's assets and liabilities. However, if the associate does not belong to an equity-accounted group of the investor, the assets and liabilities of the associate are not considered being held by the investor.

140. Certain assets held by the associate would be different in nature if these assets are owned by the investor (See Example 3.7). Also, there is a situation where the associate's assets lead to a different accounting treatment to the investor's own assets if they are owned by the investor (See Example 3.8.). The following two examples provide the cases where these considerations are necessary.

Example 3.7

Facts
An investor holds a 20% share of an associate and the associate holds the investor's shares.

Alternative 1 & 2

141. Under Alternative 1 and 2, as the associate or a portion of the associate is a part of an equity-accounted group, shares issued by the investor are treated as being owned by the investor. As a result, they are regarded as treasury shares of the investor in application of the equity method.

Alternative 3

¹⁸ An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. On acquisition of the investment, any difference between the cost of the investment and the entity's share of the net fair value of the investee's identifiable assets and liabilities is accounted for as follows.

(a) Goodwill relating to an associate or a joint venture is included in the carrying amount of the investment. Amortisation of that goodwill is not permitted.

(b) Any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is included as income in the determination of the entity's share of the associate or joint venture's profit or loss in the period in which the investment is acquired.

Appropriate adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made in order to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date. Similarly, appropriate adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made for impairment losses such as for goodwill or property, plant and equipment.

142. Under Alternative 3, the shares issued by the investor and owned by the associate are not considered as being held by the investor.

Example 3.8

Facts

An investor holds 20% of Investee A and 15% of Investee B.
Investee A holds 10% of Investee B.

Alternative 1

143. Under Alternative 1, Investee A's entire share of Investee B is considered to be held by the investor. Therefore, in considering whether the investor has significant influence over Investee B, 25% (15% held directly + 10% held by Investee A) of shares are considered to be held by the investor.

Alternative 2

144. Under Alternative 2, 20% of Investee A's share of Investee B is considered to be held by the investor. Therefore, in considering whether the investor has significant influence over Investee B, 17% (15% held directly + 20% of 10% held by Investee A) of shares are considered to be held by the investor.

Alternative 3

145. Under Alternative 3, only 15% of share of Investee B is considered to be held by the investor. Investee B's shares held by Investee A are not considered as being held by the investor.

Comparison to IAS 28 (2011)

146. The requirement for not combining shares through associates is stated in paragraph 27 of IAS 28 (2011)¹⁹. It is not clearly stated regarding the treasury shares held through the associates; however it seems that these shares are not viewed as treasury shares in practice. The requirement and the practice are consistent with Alternative 3.

Additional acquisition without status change

147. When equity method is continuously applied after acquisition of additional shares of an associate,

¹⁹ A group's share in an associate or a joint venture is the aggregate of the holdings in that associate or joint venture by the parent and its subsidiaries. The holdings of the group's other associates or joint ventures are ignored for this purpose. When an associate or a joint venture has subsidiaries, associates or joint ventures, the profit or loss, other comprehensive income and net assets taken into account in applying the equity method are those recognized in the associate's or joint venture's financial statements (including the associate's or joint venture's share of the profit or loss, other comprehensive income and net assets of its associates and joint ventures), after any adjustments necessary to give effect to uniform accounting policies.

the accounting treatment for the change in the investor's share of net asset of the associate may vary depending on which alternative is applied.

148. There are two issues in relation to additional acquisition of shares of the associate.

- The transaction may or may not be a capital transaction.
- The initial measurement of the additional investment in the associate.

Example 3.9

Facts

An investor holds a 20% of an associate and the carrying value of the investment is CU 1,000. The investor purchases an additional 10% of the associate's share from another shareholder Y for CU 600 in cash.

Alternative 1

149. Under Alternative 1, since the associate and the investor are considered to be one equity-accounted group, entity Y is an owner of the equity-accounted group. Thus, the transaction is a capital transaction with the owner of the equity-accounted group.

150. As Y is considered as an owner of the equity-accounted group, this transaction should be accounted for using the same accounting treatment that is applied to transactions that result in changes in ownership interests while retaining control in the consolidation accounting. These transactions are accounted for as transactions with equity holders in their capacity as equity holders. As a result, no gain or loss on such changes is recognized in profit or loss; instead, it is recognized in equity.

151. As the associate as a whole has been included within the scope of the equity-accounted group, the additionally acquired 10% is also included in the equity-accounted group. Therefore the additional share should not be re-measured differently from the existing 20% of shares in terms of the value per share. As a result, the 10% share that the investor additionally purchased is measured at CU 500 (the carrying value of existing 20% share of CU 1,000 * 10%/20%).

152. The fact that the existing 20% share is measured at CU 1,000 would mean that the carrying amount of the net asset of the associate in hypothetical consolidated financial statements is CU 5,000 (CU 1,000 * 100%/20%). Therefore, the additional 10% share measured at any amount other than CU 500 implies that net asset of the associate is being re-measured.

153. This investor is considered to receive 10% share of CU 500 in exchange for cash CU 600 and the difference of CU 100 (loss from the capital transaction) is recognized in equity as in the entry below.

DEBIT		CREDIT	
Equity-accounted investment	500	Cash	600
Equity	100		

Alternative 2

154. Under Alternative 2, since only the investor's share of the associate is included in the scope of equity-accounted group, the remaining 80 percent share of the associate is out of the equity-accounted group; Y, one of shareholders who own 80 percent of the shares is not an owner of the investor's equity-accounted group. Therefore this is not a capital transaction.

155. The additional acquisition should be accounted for in the same manner as the initial acquisition of investments in an associate. The transaction is accounted for as below.

DEBIT		CREDIT	
Equity-accounted investment	600	Cash	600

Alternative 3

156. Under Alternative 3, the additional investment is measured consistently with the initial recognition of financial assets (See paragraph 85).

Comparison to IAS 28 (2011)

157. Under IAS 28 (2011), additional acquisitions are not viewed as capital transaction, and therefore IAS 28 (2011) is consistent with Alternative 2 and 3.

Additional acquisition with status change from associate to a subsidiary

158. By additionally acquiring an associate's share, an investee may become a subsidiary; on the contrary, a subsidiary may become an equity-accounted associate by investor's selling shares of the subsidiary. These status changes of the associate involve other standards such as IFRS 3 or IFRS 10.

Alternative 1

159. Under Alternative 1, the investor and its equity-accounted associate already forms one single economic entity as a part of an equity-accounted group; therefore the transaction of an associate becoming a subsidiary may not be seen as changes in nature of the investment. These interpretations would cause conflict with IFRS 3, which views the transaction that deals with acquiring control over an entity as changes in the nature of the investment.

Alternative 2

160. Under Alternative 2, a portion of an associate is already seen as part of an equity-accounted group, but it is different from having the whole entity within an equity-accounted group.

161. As an example, when the investor's ownership interest is the same, e.g., 30%, there is a significant difference between having the whole entity within a group and having the 30% of the entity within an equity-accounted group. If the whole entity forms part of a group, the investor is considered to control the entire assets and liabilities of the investee although 70% of the investee's equity is attributed to NCI. However if only 30% portion of the investee forms a part of an equity-accounted group, the investor is considered to control only 30% of the entire assets and liabilities of the investee.

162. Therefore, when an equity-accounted associate becomes one of the subsidiaries, it is not a simple change in the quantitative share of ownership interest of the associate but rather a change in nature of the investment. The entire associate becomes part of a group and this event should be accounted for according to IFRS 3.

Alternative 3

163. Under Alternative 3, because it is the transaction of a financial asset becoming part of an equity-accounted group, changes in nature of the investment have occurred and IFRS 3 is applied.

Comparison to IAS 28 (2011)

164. Under IAS 28 (2011), similar to Alternative 2 or 3, the transaction of an equity-accounted associate becoming a subsidiary is a transaction that causes changes in nature of the investment and therefore, application of IFRS 3 is appropriate.

IAS 28 AND THREE ALTERNATIVES

165. In this report, the concepts of the equity method are defined using the new dimension, "Scope of Equity-accounted group." Also, we have applied each alternative into various cases of transactions that may occur during the retention of the equity-accounted investment. As a result, we were able to introduce internally consistent accounting treatments under each of all three alternatives. We compare these results to the application of the current IAS 28 (2001).

166. Table 3-4 shows the result of comparing the alternatives and the current IAS 28 (2011). As shown in Table 3-4, it is evident that the current IAS 28 (2011) contains all 3 alternatives' concepts mixed with

its current standards.²⁰

Table 3-4. Comparison of the Alternatives to IAS 28 (2011)

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

167. Under the following aspects, the elements of Alternative 1 appear,

- Consideration transferred, i.e., the transaction price in an initial acquisition needs to be allocated to identifiable assets and liabilities and goodwill is determined on the initial recognition.
- A change in investors' share of net asset caused from other capital transactions of the associated is recognized in equity.
- Uniform accounting policies are required.
- In eliminating effects of a downstream sale to an associate, liabilities are recognized when the carrying value of the equity-accounted investment becomes 0.
- When the associate recognizes impairment loss for its individual asset, the investor's share of the associate's profit or loss after acquisition is appropriately adjusted so that impairment losses of goodwill or PP&E of the associate are calculated based on their fair values at the acquisition date.

168. Under the following aspects, the elements of Alternative 2 appear,

²⁰ In assessing the current state, the most recently published ED was also considered.

- Consideration transferred, i.e., the transaction price in an initial acquisition needs to be allocated to identifiable assets and liabilities and goodwill is determined during the initial recognition.
- Uniform accounting policies are required.
- Any gain or loss resulting from transactions from an associate eliminates only the share of the investors.
- In eliminating effects of a downstream sale, liabilities are recognized when the carrying value of the equity-accounted investment becomes 0.
- When the associate recognizes impairment loss for its individual asset, the investors' share of the associate's profit or loss after acquisition is appropriately adjusted so that impairment losses of goodwill or PP&E of the associate to be calculated based on their fair values at the acquisition date.

169. Under the following aspects, the elements of Alternative 3 appear,

- When initially recognized, transaction costs are included in initial measurement of the investment.
- When the carrying value of the investment becomes 0, further losses of an associate are not reflected by ceasing the equity method.
- When eliminating transactions with an associate, the underlying transaction is not eliminated.
- Impairment loss of the investment is not allocated to the individual asset of the associate.
- Indirect holding of other associate's share through associates is ignored.
- In the case that an associate holds the investor's shares, it is not treated as a treasury share.

SUMMARY

170. This chapter suggests the new dimension, "scope of equity-accounted group," to define the underlying concepts of the equity method. This chapter also establishes three concepts of the equity method, in each of which the equity method accounting is more internally consistent.

171. We discuss the differences between the three alternatives by applying them to typical transactions.

172. Compared to the alternatives, the current IAS 28 contains many inconsistencies.

CHAPTER 4 ISSUES TO CONSIDER BASED ON EXPERIENCES OF KOREA UNDER KOREAN GAAP

173. As mentioned in “Equity Method in Korean GAAP” section of Chapter 2, prior to the adoption of IFRS in 2011, companies in Korea had used stand-alone financial statements as the primary financial statements, and the equity method had been applied to account for associates and subsidiaries in the stand-alone financial statements to achieve the same effect of consolidation. For these reasons, the equity method has been developed as one of the most important accounting standards in Korea. Various issues emerged in practice, and discussions and research on equity method were actively carried out to address these issues. Commonly seen issues include what specific accounting treatment should be used in applying equity method accounting, as well as how to address the differences in the net asset change between the consolidated financial statements and the equity method applied stand-alone financial statements.

174. The experience of Korea could provide insights to the IASB in its research project for amending IAS 28.

HISTORY OF EQUITY METHOD IN K-GAAP

175. The history of the equity method in K-GAAP can be divided into three phases; before 1998 (Phase I), from 1998 to 2003 (Phase II), and after 2004 (Phase III).

176. During Phase I, the equity method was required only for associates on the consolidated financial statements. The equity method was not required for associates or subsidiaries in the stand-alone financial statements. In addition, associates were not required to be presented separately from other financial assets in the stand-alone financial statements.

177. Phase II can be characterized by the expanded application of the equity method. In 1998, K-GAAP was amended to establish the equity method as one of the accounting treatments for “investment security”. The purpose of the amendment was to bring the effect of consolidation into the stand-alone financial statements. As a result, in addition to the existing requirement, the equity method was required (1) for both associates and subsidiaries and (2) in the stand-alone financial statements.

178. At the beginning, the standard on the equity method contained only three basic principles: (1) when the investor holds over 20% of the voting power of the investee, the investor shall be determined to have significant influence over the investee; (2) the investee on which the investor has significant influence is accounted for by the equity method; and (3) subsequent to acquisition, the investor’s share of the associate’s profit or loss is recognized as investor’s profit or loss, and the investor’s share of changes in the associate’s equity is recognized as changes in investor’s equity.

179. However, as the equity method was applied to the stand-alone financial statements, diverse issues arose in practice which could not be solved by the above three high-level principles. Therefore, the Financial Supervisory Service (FSS) of Korea announced Interpretation No. 42-59, guidance for

various accounting treatments regarding the equity method, in 1999. Interpretation No. 42-59 included detailed criteria for assessing significant influence, requirement on accounting treatment for the difference between the consideration paid and the fair value of the associate's net asset (goodwill), detailed guidance on how to eliminate the unrealized profit or loss from transactions with associates, and requirement on accounting treatment when investor's ownership interest of the associates changes.

180. Even after Interpretation No. 42-59 was issued, new issues regarding the equity method continued to emerge. In fact, from 2001 to 2004, the KASB provided 83 Interpretations in response to the inquiries on the equity method, and the FSS also provided a large number of responses to consultations from companies.

181. During Phase III, the equity method for subsidiaries was introduced for the first time. The Statement of Korean Accounting Standards of "Equity Method" was issued in 2004. It included all the interpretations that had been issued on the equity method. It also introduced an equity method exclusively for subsidiaries, which was different from the equity method for associates.

182. Even after Korea had fully adopted IFRS in 2011 for listed companies, K-GAAP has still been applied for non-listed companies. As mentioned above, the equity method in K-GAAP includes requirements for very specific accounting treatments. On the contrary, IAS 28 includes only basic principles regarding the equity method. As a result, listed companies in Korea often encounter practical difficulties due to the lack of specific guidance, while non-listed companies do not.

183. To address the requests for practical guidance, the IASB has worked on three amendment projects of the equity method²¹. However, there are practical issues that are not expected to be resolved by the outcome of the three amendment projects, which will be further explained later in this paper, which the IASB should consider.

184. Korea has experience of dealing with many practical issues related to the equity method. Therefore the IASB may consider taking advantage of the useful insights from Korea's experience in regards to future amendments on IAS 28.

185. Hereafter, we would like to share Korea's experience on the following issues - equity method for subsidiaries under K-GAAP, equity method for associates under K-GAAP, limitations of equity method as one-line consolidation, and expected issues from allowing the equity method in separate

²¹ Since 2010, IASB has been working on three amendment projects on the equity method: (a) *ED Equity Method: Share of Other Net Asset Changes*, b) elimination of gains or losses arising from transactions between the entity and its associate and joint venture, and c) sale or contribution of assets between an investor and its associate or joint venture. The IASB decided not to proceed Project (a) any further in May 2014, and made a final decision on Project (c) and announced the amendment of IAS 28 in September 2014. Also, IASB issued the amendment of IAS 27: *Equity method in separate financial statement* in August 2014.

financial statements, based on the Korea's experience in applying the equity method.

EQUITY METHOD FOR SUBSIDIARIES UNDER K- GAAP

186. Since 1998, Korea has expanded the application of the equity method to subsidiaries. Specifically, K-GAAP requires the investor to apply the equity method not only to associates but also to subsidiaries when it prepares the stand-alone financial statements. Since a significant number of Korean companies did not prepare consolidated financial statements but only the stand-alone financial statements²², the KASB purported to use the equity method to show the effect of consolidation in the stand-alone financial statements.

187. When the KASB made the amendment, the KASB expected that the equity method would bring exactly the same effect of consolidation to the stand-alone financial statements (e.g., net income of the stand-alone financial statements should be the same as the net income that is attributable to parent in the consolidated financial statements) because theoretically the equity method is one-line consolidation.

188. However, there were many instances where consolidated financial statements and stand-alone financial statements were not consistent with each other. One of the reasons is that the result of the equity method applied in subsidiary is not consistent with the result of the consolidation. In order to correct this problem, equity method accounting for subsidiaries was introduced in 2004 through amendment to K-GAAP.

189. The equity method accounting for subsidiaries in K-GAAP aligns net profit or loss and net asset 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. To make the effect of the equity method for subsidiary the same as that of consolidation, distinct rules have been introduced only for the equity method for subsidiaries. The major differences between the equity method for subsidiary and the equity method for associate are as follows:

189.1. First, elimination of unrealized profit/loss in downstream transactions. The unrealized profit or loss that occurs through downstream transactions between investors and subsidiaries is fully eliminated, while it is eliminated at the portion of the investor's interest in the equity method for associates.

189.2. Second, acquisition and disposal of subsidiary's shares that does not affect the status between the investor and the subsidiary. The acquisition of the interest of subsidiary without any change in status is accounted for as the change of non-controlling interest in consolidation;

²² Before 2010, K-GAAP required only the large listed companies to prepare and disclose consolidated financial statements.

when there is a partial disposal of a subsidiary's share without change in control, the difference between the consideration received and carrying amount is included in capital surplus (or capital adjustment) but not in profit and loss in consolidation. Therefore, in the equity method for subsidiaries, those transactions are accounted for as changes in equity. Under the equity method for associates, the result of the partial disposal is accounted for in profit or loss, and the additional acquisition is applied as partial step-up acquisition, whereby goodwill is calculated on the incremental interest acquired as a residual after valuing the incremental share of identifiable net assets at fair value.

189.3. Third, the changes in subsidiary's equity due to the issuance of new shares and other equity transactions without changing the status. In this case, the difference between (a) and (b) is recognized as equity under the equity method for subsidiaries, while the equity method for associates accounts it for a transaction based on the nature of the transaction.

- a) Acquisition cost for the newly acquired shares
- b) The value calculated based on the carrying value of the existing shares

189.4. Fourth, investor's recognition of the impairment of the account balances incurred from the transactions between the investor and subsidiaries. When the investor recognizes an impairment loss of the receivables due from a subsidiary, it is reversed as receivables and the impairment loss is fully eliminated in consolidation. Therefore, to present the same effect, the impairment loss is reversed in investor's financial statements under the equity method for subsidiaries. However, no adjustment is required in the equity method for associates.

189.5. Fifth, the accounting treatment for obtaining control through additional acquisition of shares. When the acquisition of additional interest results in obtaining control (i.e. an associate becomes a subsidiary), under the equity method for subsidiaries, the entire investment is re-measured at fair value for the initial recognition. Under the equity method for associates²³, the 'partial-step up' approach is applied for additional acquisition of associate's shares.

190. Table 4-1 summarizes the differences between the equity method for subsidiaries and for associates under K-GAAP.

Table 4-1 Differences between the Equity Method for Subsidiaries and for Associates under K-GAAP

	Equity method for subsidiaries	Equity method for associates
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²³ For the comparison of the equity method for subsidiaries and the equity method for associates, we assume that significant influence does not change. In stand-alone financial statements under K-GAAP, the change in control was not considered before Phase III.

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
Additional “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

191. Beside the issues presented above, there have been numerous other issues related to the equity method for subsidiaries. There have been about 30 interpretations regarding the equity method for subsidiaries that were published by the KASB and the FSS from 2005 to 2012. Among these, we would like to share two cases to better understand the differences between the equity method for associates and subsidiaries under K-GAAP.

191.1. Case 1. When a parent company sells AFS securities at fair value to a subsidiary, there may be difficulties in deciding whether the gain or loss on disposal should be recognized as OCI or as profit or loss. If this were a case for an associate, profit or loss would be reasonable. However, since the AFS securities are sold to a subsidiary, the group continuously holds the AFS securities; therefore, the gain or loss on disposal should not be recognized in consolidation. Also, in applying the equity method accounting, the gain or loss on disposal should not be recognized as profit or loss. (KQA 2006-015)

191.2. Case 2. If a subsidiary owns its parent’s shares, it shall be considered as treasury shares even when applying the equity method. Therefore, the parent shall not recognize the gain or loss from a disposal of the treasury shares to a third party in consolidation and the application of equity method. However, the subsidiary recognizes the gain or loss on disposal as a profit or loss since it is classified as FVTPL securities in its financial statements. (KQA 2007-007)

EQUITY METHOD FOR ASSOCIATES UNDER K-GAAP

When associates issue preference shares²⁴

192. The accounting treatment for the preference shares in the current IAS 28 (2011) is rather simple; when a cumulative preference share is issued by an associate, the investor recognizes its share of associate's profit or loss after adjusting for the dividends on the preference share, regardless of whether the dividends are declared.²⁵ However, preference shareholders could have a variety of entitlements to net profit distribution such as full participation, partial participation, etc. Therefore, when an associate issues preference shares, in applying equity method accounting, the investor of the associate shall present its access to the associate's net assets by considering various conditions and entitlement of the preference shares.

193. As a result, in applying equity method, the investor of an associate with preference shares outstanding should consider the conditions of the preference shares to determine the appropriate percentage of investor's interest. For example, occasionally the preference shareholders have liquidation preference over the ordinary shareholders. In this case, the investor may have to calculate its share of the associate's equity after adjusting for the dividends on the preference shares in determining the appropriate portion of ownership interest. However, the current IAS 28 (2011) remains silent on this matter.

194. Through the following example, we could examine the practical issues that may occur when specific conditions are given in regards to the liquidation preference.

Example 4.1

Facts

Company A (Investor): purchases 30% of ordinary share issued by Company B (Company A has significant influence on Company B) at CU 100 at Year 1.

Company B (Associate): issued ordinary shares (30% of voting rights) and convertible redeemable preference shares (70% of voting rights)

Year 1, Company B recorded net loss of CU 100.

Year 2, Company B recorded net profit of CU 150.

At the end of Year 1, Company B's net asset is CU 0.

²⁴ Types of equity instruments issued by an investee and their respective conditions may vary by each jurisdiction's statute. Therefore, further diverse views may arise. However, for illustration purposes, discussions in this paper are limited to the accounting issues about preference shares, which is the most common equity instrument other than ordinary share.

²⁵ IAS 28 paragraph 37 states that "If an associate or a joint venture has outstanding cumulative preference shares that are held by parties other than the entity and are classified as equity, the entity computes its share of profit or loss after adjusting for the dividends on such shares, whether or not the dividends have been declared."

Upon liquidation, the preference shareholders will receive at least the amount which it would have received if it had exercised the redemption right, even if Company B records the accumulated loss.

When the Investor (Company A) applies equity method on Company B, how does the Investor recognize Company B's loss?

195. The current IAS 28 only mentions that the investor shall recognize the amount that applies to the investor's share out of investee's net profit or loss.²⁶ Therefore, accounting treatments under IAS 28 (2011) can vary depending on how Company A's equity is defined. In the above example, three approaches are possible as follows:

- *Approach 1:* The investor's share is defined as the ownership interest of the investor without considering the liquidation preference. Thus, the investor (Company A) recognizes the associate's (Company B's) net profit or loss to the extent of its ownership interest (i.e. 30%). Then, the investor recognizes a loss of CU 30 ($CU100 \times 30\%$) in year 1, and a profit of CU 45 ($CU150 \times 30\%$) in year 2. As a result, the carrying value of the associate is CU 115 ($CU100 - CU30 + CU45$) in Company A's financial statements at the end of year 2.
- *Approach 2:* The investor's share represents 100% obligation to the associate's loss. Therefore, the loss of the associate is fully attributable to the investor due to the preference liquidation clause. In the example, Company A recognizes 100% of Company B's net loss (i.e., CU100) in year 1. In year 2, the Company A recognizes a profit of CU45 ($CU150 \times 30\%$) proportionate to its ownership interest. As a result, the carrying value of the associate is CU 45 ($CU100 - CU100 + CU45$) at the end of year 2.
- *Approach 3:* The investor's share represents 100% obligation to the associate's loss, and 100% right to the associate's gain to the extent of the associate's cumulative losses. Thus, the associate's loss is fully attributable to the investor. The associate's gain is fully attributable to the investor until the associate's accumulated losses become zero; after the accumulated losses are fully recovered, the investor recognizes profit in proportion to its ownership interest. In the example, Company A recognizes the loss amounting to CU100, 100% of Company B's net loss in year 1, and Company A recognizes CU115 ($CU100 \times 100\% + 50 \times 30\%$) in profit in year 2. As a result, the carrying value of the associate, Company B, is CU115 ($CU100 - CU100 + CU115$) at the end of year 2.
- Consequently, the results of the equity method applied to Company A are quite different

²⁶ IAS 28, par. 10 "Under the equity method, on initial recognition the investment in an associate or a joint venture is recognised at cost, and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition."

under the three approaches as summarized below:

	Approach 1	Approach 2	Approach 3
Investor's share	Proportion to ownership interest	Loss – 100%	Changes in accumulated deficit – 100%
		Profit – 30%, proportion to ownership interest	Changes in retained earnings– 30%, proportion to ownership interest
Year 1	Net loss CU 30	Net loss CU 100	Net loss CU 100
Year 2	Net profit CU 45	Net profit CU 45	Net profit CU 115
Carrying value of the associate	CU 115	CU 45	CU 115

196. K-GAAP adopted Approach 3 because it appropriately represents the rights and obligations of the investor.

197. The example above is rather a simple example. But the real cases could be more complex. K-GAAP provides specific guidance even for more complex cases.

198. For an example of more complex case, assume that an associate issues preference shares when an investor owns both the ordinary and preference shares of the associate. When applying the equity method, K-GAAP requires to divide the associate's net assets into ordinary shareholder's interest and preference shareholder's interest. The reason is that, when various rights are attached to preference shareholders such as the liquidation preference and full participating or partial participating rights on dividends, the equity method cannot be applied without adjusting the economic substances of those rights. The calculation method of the ordinary shareholders' equity and the preference shareholders' equity under K-GAAP is as follows:²⁷

²⁷ The results of applying K-GAAP to Example 4.1 are summarized below.

	At initial recognition	Year 1	Year 2
Ordinary shareholders' equity	CU 0	(CU100)	CU15 (30% of CU 50)
Preference shareholder's equity	CU 0	CU 0	CU 35 (70% of CU 50)
Carrying value of Company B in Company A's Financial Statements	CU 100	CU 0 (CU 100-CU100)	CU 115 (CU 0+CU115 – i.e. the changes in ordinary shareholders' equity)

Case I. When both preference shareholders and ordinary shareholders hold equal right of liquidation dividend

Preference shareholders equity = equity of preference shareholders / (equity of preference shareholders + equity of common shareholders) * total equity of associates

Case II. When preference shareholders have the right of liquidation preference.

Preference shareholders equity = ratio in accordance with the terms * equity of associates

199. As we can see in the above example, the equity method can have different effects on the financial statements depending upon how the investor's share (or right) on the associate's net equity is defined and interpreted. Therefore, the IASB should consider establishing specific guidance on IAS 28 for situations where the associate issues preference shares, and where the investor holds both of the associate's preference and ordinary shares.

Investor's classification of preference share when the issuer (associate) classifies it as a liability

200. Although preference shares are classified as equity under K-GAAP, IAS 32/IFRS 9 requires the issuer to classify preference shares as equity or a liability based on the terms and conditions of the instruments. Meanwhile, IAS 28 requires investors to consider only the voting rights embedded in preference shares when assessing whether it has significant influence over the issuer, and does not consider how the shares are classified by the issuer.

201. These seemingly clear accounting principles could cause a problem in the situation where an investor owns preference shares which are classified as a liability by the associate (issuer). An extreme case is where the investor classifies the preference shares as equity-accounted investment in accordance with IAS 28, while the associate classifies it as a liability in accordance with IAS 32. In that case, the associate accounts for the dividend on the preference shares as interest expense, while the investor recognizes the dividend as a reduction to investment balance.

202. In addition, this inconsistency in the classification of the preference shares between the investor and the associate is clearly inconsistent with the underlying viewpoint of IFRS 9. IFRS 9 views that the classification of liabilities or equity in the issuer's financial statement should be aligned with the classification of debt instrument or equity instrument in the investor's financial statements. Under IAS 28 (2011) it is unclear whether the debt instrument with voting rights shall be considered or not when assessing the significant influence. Therefore, the IASB should consider how to assess significant influence when the investor holds preference shares which are classified as debt instruments with voting rights.

203. To summarize, under the current environment where various types of preference shares are being issued, the IASB needs to contemplate whether specific guidance should be provided for the

investors who own associates' preference shares, in order to avoid the diversity in accounting treatment and the possible distortions in accounting information. In addition, consideration is needed in regards to the contradiction between IAS 28 and IAS 32/ IFRS 9.

Impairment of associates and reversals

204. The accounting treatment for impairment on the equity accounted investment under IAS 28 is as follows:

- a) The indicator of impairment is evaluated according to IAS 39/IFRS 9.
- b) Impairment test is carried out by using associate's operating cash flow or the investor's cash flow from dividends following IAS 36.
- c) Impairment loss recognized for investments in associates is not allocated to the underlying assets (i.e. goodwill) of the associates.
- d) The impairment loss of investment in associates could be reversed in full.

205. As described in Paragraph 138, the impairment accounting in IAS 28 has a mixed view of consolidation and measurement. To summarize again, the fact that an investor should follow IAS 39/IFRS 9 in identifying indicators of impairment and that recognized impairment is not distributed to the associate's underlying asset is consistent with the measurement concept. However, it also has the consolidation concept, since the impairment test is required to follow IAS 36.

206. K-GAAP's accounting treatment for associate's impairment is not consistent with IAS 28. Since K-GAAP has the view that the investor owns a part of the associate to the extent of its interest, it is assumed that the investment in associate is composed of associate's net asset at carrying value, fair value adjustment (i.e., associate's net asset at fair value in excess of carrying value), and goodwill. Specifically, the following major accounting treatments under K-GAAP are different from IAS 28 with the exception of a).

- a) The indicator of impairment is evaluated according to Financial Asset accounting standards.
- b) Impairment test is carried out by using associate's operating cash flow or investor's cash flow from dividends.
- c) When there are unamortized fair value adjustments or goodwill, the impairment loss is allocated to goodwill first.
- d) The reversal of impairment loss is allowed to the extent that the impairment loss was not allocated to goodwill.

207. By taking a simple example below, we could find differences in the impairment accounting on equity accounted investment between IAS 28 and K-GAAP.

Example 4.2

Facts	
<p>Company A paid CU 100 for a 30% interest of Company B and obtained significant influence on Company B.</p> <p>The net book value and fair value of Company B is zero at the acquisition date.</p> <p>The entire consideration for investment is allocated to goodwill.</p>	
<p>Year 1</p> <p>Total investment shall be recognized as impairment loss (i.e., recoverable amount is zero) due to the significant decline in sales of the associate (impairment indicator).</p>	
IAS 28	K-GAAP
The impairment loss is not allocated to goodwill, but regarded as a deduction from the book value of the investment on the associate.	The impairment loss is allocated to goodwill.
<p>Year 2</p> <p>Company B's net profit is zero, and foreign currency translation reserve (OCI) of CU 100 is recognized.</p> <p>The business of Company B has recovered, and the impairment indicator no longer exists.</p>	
IAS 28	K-GAAP
The valuation on equity-accounted investee in OCI of CU 30 and reversal of the impairment loss CU 100 is recognized.	The valuation on equity-accounted investee in OCI of CU 30 is recognized. However, no reversal of the impairment loss is recognized.

208. The IASB once considered the same accounting treatment of impairment loss as in K-GAAP. One of the reasons why the IASB decided not to allocate the impairment loss to goodwill is well explained in BCZ45 of IAS 28, "The Board decided that an entity should not allocate an impairment loss to any asset that forms part of the carrying amount of the investment in the associate or joint venture because the investment is the only asset that the entity controls and recognizes." The underlying reason of BCZ45 is very similar to that of Alternative 3 that we proposed in Chapter 3, which sees equity accounted investment as a financial instrument.

209. As IAS 36 is applied for the impairment test of investments in associates, it seems that the IASB has a view that the associate is regarded as a part of the investor's business, similar to subsidiaries. However, the allocation of impairment loss is applied differently to the associates and the subsidiaries. The impairment loss related to subsidiaries is allocated to relevant goodwill first and

reversal is prohibited, while the impairment loss on associates is recognized as the deduction of the carrying value of the associates and fully reversible. This accounting difference is not consistent with the accounting for initial recognition of both investments, i.e. subsidiary and associate. At initial recognition, the acquisition cost for both subsidiaries and associates is allocated to goodwill. This difference in the impairment accounting between associates and subsidiaries is seemingly inconsistent. .

210. Another point to be considered is the inconsistency between IAS 39 and IAS 28 in their recognition of the reversal of impairment. IAS 39 does not allow the reversal of impairment in investment in AFS equity instrument to be recognized in profit or loss but requires it to be recognized in other comprehensive income. On the other hand, IAS 28 allows the reversal of impairment in associates to be recognized in profit or loss.

211. We consider that the impairment accounting in associates under IAS 28 shows the apparent mixed viewpoints.

Allocation of impairment loss

212. Under K-GAAP, when the investor recognizes impairment loss for investment in associates, the investor's share of other comprehensive income in the associate is recycled. This is to provide the consistency for both impairment loss and accounting for change in net asset of the associates. However, IAS 28 recognizes impairment loss for the associates in current profit or loss without recycling OCI. For better understanding of the accounting under IAS 28 and K-GAAP, we have provided an example as below.

Example 4.3

Facts			
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.			
<ul style="list-style-type: none"> Accounting treatments upon impairment recognition under K-GAAP and IAS 28 are as follows, respectively. 			
K-GAAP		IAS 28	
DEBIT	CREDIT	DEBIT	CREDIT
Impairment loss 30 OCI – associate 30	Associate-B 60	Impairment loss 60	Associate – B 60

213. Under IAS 28, the investor's share of the associate's other comprehensive income is not reversed when it recognizes the impairment loss of the associate. 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.

Equity method: Share of other net asset changes

214. Since 2012, the IASB did research in order to provide application guidance on how to apply the equity method when associates experience "other" net asset changes. *ED/2012/3 IAS 28 Equity Method: Share of Other Net Asset Changes* was published in November 2012²⁸ containing guidance on this issue as follows:

The changes in the investor's share of the investee's net assets arising from changes in the equity of the investee that are attributable to the investor, other than profit or loss or other comprehensive income and distributions received, are recognized in the investor's equity. Those changes include:

(i) changes in the equity of the investee that result in a change in the investor's ownership interest in the investee, as a consequence of, for example, the issue of additional shares to third parties or the buy-back of shares from third parties by the investee, or the issue of shares by the investee on exercise of share options granted by the investee under an equity-settled share-based payment; and

(ii) changes in the equity of the investee that do not result in a change in the investor's ownership interest in the investee, but are attributable to the investor, such as, share options granted by the investee under an equity-settled share-based payment that lapse unexercised, or transactions between the investee and the non-controlling interests in the investee's subsidiary

215. Though the IASB's proposal in the ED does not clearly state which viewpoint (consolidation or measurement) is applied, the proposed ED is consistent with Alternative 1 which we proposed in Chapter 3. In other words, it seems that the IASB considers this case as a transaction between an equity-accounted group and its owner, which is different from the viewpoint of many other accounting treatments in IAS 28.

216. However, accounting treatments of Alternative 2 seem more common in practice than Alternative 1. We also find the following paragraph from "IFRIC Update 2013.7" suggesting that the Interpretations Committee does not seem to support Alternative 1:

"The Interpretations Committee observed that, under the equity method, the investor accounts for the share of the other net asset changes in carrying amount of its investment if such changes arise. ***A change in the carrying amount of the investment caused by the other net asset changes is an increase or decrease in the investor's assets and is not related to contributions from, or distributions to, equity participants.*** Consequently, the Interpretations Committee noted that, from an investor's perspective, other net asset changes of an investee meet the definition of income and

²⁸ IASB decided that they will not proceed the ED any further on May 2014 meeting.

expenses as set out in the Conceptual Framework. In addition, the Interpretations Committee noted that the other net asset changes represent performance of the investor's investments."²⁹

217. In K-GAAP, when the ownership interest of associates changes due to the change in the associate's equity from the issuance of new shares, the accounting treatments for those transactions are depicted in detail based on whether it is deemed as disposal or acquisition.

218. When changes in the equity are reported by associates (including capital reduction, stock dividend, and capital reduction without refund), the investor's ownership interest of the associate may change. In K-GAAP, increase in the investor's ownership interest due to these transactions is viewed as additional acquisition of shares, and therefore is accounted for by recognizing the differences between the additional acquisition cost and the increment in the investor's share of the associate's carrying amount (i.e. goodwill). In contrast, decrease in the investor's ownership is regarded as partial disposal of the shares (while maintaining significant influence). This accounting treatment under K-GAAP is consistent with Alternative 2.

219. To assist you with better understanding, we have provided an example below.

Example 4.4

Facts
<ul style="list-style-type: none"> ▪ An associate issued new shares only to the shareholders other than the investor. ▪ The associate's net asset increases from CU 100 to CU 140. ▪ The investor's interest decreases from 30% to 25%.
Effect of dilution
<p>The investor's share of the associate's net asset before the issuance of new shares: $CU\ 100 * 30\% = CU\ 30$</p> <p>The investor's share of the associate's net asset after the issuance of new shares: $CU\ 140 * 25\% = CU\ 35$</p> <p>As a result of the issuance of new shares by the associate, change of CU 5 occurs.</p> <p>This change amount has the same nature as disposing 5% of the shares to other shareholders; therefore it is recognized as profit or loss on disposal under K-GAAP.</p> <p>However, this change amount is recognized as equity under <i>ED/2012/3 IAS 28 Equity Method: Share of Other Net Asset Changes</i>.</p>

220. K-GAAP has a view that the change of investor's ownership interest in the associate due to the associate's equity transactions has the same inherent nature as the change of investor's ownership interest due to the actual disposal or acquisition of investor's shares in the associate.

²⁹ IFRIC Update 2013. 7, with highlight added.

221. However, the accounting treatment proposed in the IASB's ED differs from that of K-GAAP and major accounting firms.

Cross-holding interest

222. The issue is about the accounting treatment for a change in share amount in the case of having cross-holdings (or reciprocal interests). K-GAAP provides specific accounting guidelines for cross-holdings (e.g., Company A and Company B each owns 30% of the other entity's share, respectively) and circulation of ownership (e.g. Company A owns 30% of Company B's share, Company B owns 30% of Company C's share, and Company C owns 30% of Company A's share).

223. The cross holdings might give rise to a measure of double-counting of profits or losses and the equity between the investor and its associate. However, the IASB is silent on this issue, even though it is important for jurisdictions where the cross holdings or reciprocal interest are common.

224. Therefore, accounting for the elimination of internal transactions within an equity-accounted group could be applied by analogy in accordance with paragraph 27 of IAS 28 or with IFRS 10. Theoretically, there are a number of possible methods in dealing with cross-holdings, i.e. full gross up without elimination, economic interest of non-controlling interests, direct holding (or net approach) and so on.³⁰ K-GAAP provides the guidance for the cross-holding, i.e. full gross up method without elimination.

225. There have been many controversies regarding the current IAS 28 'Investments in Associates and Joint Ventures.' The current IAS 28 is criticized for not properly providing specific guidance in numerous cases, and even when guidance is given, it is often vaguely stated. As a result, diverse guidance has been executed by each major accounting firm on a case-by-case basis, therefore causing inconsistencies within the standard. Consequently, there have been numerous requests and opinions on the need for more specific additional guidance for consistent application of the equity method.

226. The controversies exist not only for the currently effective IAS 28 but also for the process of developing additional guidance on IAS 28. On December 2012, as part of the narrow scope project for IAS 28, the IASB published the Exposure Draft ED/2012/3 IAS 28 Equity Method: Share of Other Net Asset Changes, which is another case of the inconsistency within the standards. In their comments, respondents believe that this ED includes inconsistencies within the standard. Arguments and controversies such as these serve as a sign that inconsistencies may exist in not only the current standard and the standard that is presently being developed but also in the standard that will be developed in the future.

³⁰ For details, please refer to International GAAP 2013 published by Wiley (pp. 772 ~ 777).

LIMITATIONS OF EQUITY METHOD AS ONE-LINE CONSOLIDATION

227.K-GAAP has viewed the equity method as a consolidation technique. Therefore, Korea has attempted to align the effects of consolidation and the equity method. Despite the efforts, the same effect was not achieved because of the limitations in the equity method. Hereafter, we would like to briefly address the issues.

228.The most fundamental limitation can be found in the case where the associate's carrying value is below zero. K-GAAP also recognizes this limitation and allows this case as an exception - when the subsidiary's carrying value is below zero, the equity method does not need to reflect the same effect with the consolidated financial statements.

229.Secondly, when eliminating the internal transactions within an equity-accounted group, relevant balances and transactions are not fully eliminated under the equity method. Therefore, each line on the stand-alone income statement other than net profit or loss does not match with that of the consolidated income statement.

230.Thirdly, when the equity method is applied for SPEs or VIEs where the ownership interest is low, the object of the consolidation is not achieved by the equity method. In the case of SPE or VIE, the objective of the consolidation is to present the liabilities in investor's financial statements even if the investor does not have any shares of SPE or VIE. Since the equity method accounts for the associates' net asset to the extent of the investor's interest, there could be cases where nothing is recognized under the equity method.

EXPECTED ISSUES WHEN THE EQUITY METHOD IS ALLOWED IN THE SEPARATE FINANCIAL STATEMENTS

231.In August 2014, the IASB issued the amendment of IAS 27: *Equity Method in Separate Financial Statements (IAS 27 (2014))*, which allows the equity method in the separate financial statements.

232.This is not the first time that the IASB has considered to allow the equity method in the separate financial statements. According to IAS 27's BC para. 9-10, in 2003, the IASB has decided to prohibit the usage of the equity method in the separate financial statements because the equity method in the separate financial statements provides information redundant with the consolidated financial statements. Also, it states that for the separate financial statements, the focus is upon the performance of the assets as investments. The IASB changed its position on the issue of allowing the equity method in the separate financial statements; interestingly, however, the IASB did not elaborate on what made the IASB change the decision in the IAS 27 (2014).

233.Moreover, the amendment of IAS 27 may cause a number of issues, which the IASB should take into consideration, as follows :

234.First, considerations on what the objective of the separate financial statements is and what

information should be provided through the separate financial statements.

234.1. Under current IFRS, the separate financial statements are defined as financial statements that provide information about the financial performance and position of a single-entity as supplemental financial statements to the consolidated financial statement. In other words, for subsidiaries, associate and joint ventures (JV), the separate financial statements reflect their performances only as an investment asset and those investments are not measured periodically based on the changes in the net assets of the investees. Therefore, the separate financial statements provide differentiated information from the consolidated financial statements.

234.2. In other word, investments in subsidiaries and associates are viewed as a financial asset (measured at fair value or cost), outside of the equity-accounted group in the separate financial statements.

234.3. Thus, if the equity method is allowed for subsidiary, associate and JV investment as suggested by IAS 27 (2014), and the scope of equity-accounted group is expanded to investor's share for investee as explained in Chapter 3, the concept and purpose of the separate financial statements may become confusing.

235. Second, consideration should be given to whether the separate financial statements which apply the equity method to subsidiaries and associates will provide more valuable information to the information users compared to the current separate financial statements. In other words, there could be a question on whether or not they can provide differentiated information from the consolidated financial statements. In Korea, Han and Park (2013), who conducted research on Korean companies, reported that the value relevance of consolidated financial statements is statistically indifferent from that of the separate financial statements that use the equity method. Also, Yoo and Cha (2014) reported that the incremental value relevance of the equity method is smaller than that of the cost method when it is applied to the consolidated financial statements. These results suggest that when the equity method is applied to the separate financial statements, the information usefulness may in fact decrease. We can reasonably expect that the information derived from separate financial statements that have applied the equity method to a subsidiary as having no incremental value compared to the information provided by consolidated financial statements in the market.

236. Third, consideration should be given on the inconsistencies that may occur with the consolidated financial statements when the equity method is applied to separate financial statements.

236.1. As described in paragraphs 227 to 230, information provided by the consolidated financial statements and the separate financial statements are inevitably inconsistent due to the inherent limitations of the equity method and the mixed viewpoint of IAS 28. Currently, IAS 27 (2014) does not mention how to resolve the inconsistency with the consolidated financial

statements in applying the equity method for a subsidiary in the separate financial statements. The IASB just mentions that there could be situations in which applying the equity method in separate financial statements to investments in subsidiaries would give a different result compared to the consolidated financial statements.

236.2. As previously explained in relation to the experiences of Korea, mismatch of the information is inevitable due to the limitations of the equity method and the differences between the accounting in consolidation and equity method for a subsidiary. Therefore, by referring to Korea's experiences, considerations can be made on how to define the subsidiary equity method accounting differently from the equity method that applies to associates.

237. Lastly, the fact that the majority of the countries adopted IFRS in recent years should be taken into account. The majority of the adopters may be going through difficulties with enactment and amendment of the major standards, right after adopting IFRS.

238. For example, in the case of Korea in 2011 around the time of adopting IFRS, various regulations related to the previous stand-alone financial statements under K-GAAP have been amended upon adopting IFRS to reflect the differences between the stand-alone financial statements under K-GAAP and the separate financial statement under IFRS. It should be noted that not only these policies have been amended upon the adoption of IFRS but this is the period when the information users were painfully adapting to the changes where consolidated financial statements became the primary financial statements and the separate financial statements that do not apply the equity method are provided. However, if the equity method is applied to the separate financial statements again, then confusion will arise again for the information users in adapting to the new separate financial statements.

239. Consequently, the IASB should cautiously deliberate how to address the issues raised from allowing the equity method option on the separate financial statements. Once the equity method is allowed, not only does the separate financial statements' purpose change but the information provided to financial information users changes as well. In addition, by allowing the equity method on the separate financial statements, aside from the information provided by consolidated financial statements, it should be verified as to whether valuable information is in fact provided to the market through additional research.

SUMMARY AND CONCLUSION

240. We would like to emphasize again that the issues listed herein are based on the experiences of Korea. We do not address all the accounting treatments under K-GAAP which the IASB may wish to consider in this report. Korea has extensive experience in applying the equity method in the stand-alone financial statements, however, we focus on a few issues discussed above. Other issues are extremely technical and we can share those issues with the IASB upon request.

241. The equity method has been applied to the associates in consolidated financial statements. However, the IASB allowed the application of the equity method in the separate financial statements. This means that the equity method is expanded to the separate financial statements and subsidiaries as well. In that case, the impact of the equity method on financial statements will be material, and the issues we discussed in this chapter will likely result in significant problems in application. Therefore, we recommend the IASB consider carefully those issues we explained in this chapter.

CHAPTER 5 VALUE RELEVANCE OF EQUITY METHOD – A MARKET-BASED STUDY

242. This chapter provides empirical evidence on the relative usefulness between the equity method and cost method using listed companies in the Korea stock market. Among those companies, we use the parent companies with associates in order to provide some insights into the usefulness of the equity method and cost method in terms of value relevance of book value of equity and net income.

BACKGROUND

243. The current K-IFRS allows the cost method or the fair value method for associates and subsidiaries in the separate financial statements. For the consolidated financial statements, the equity method is regulated to be applied to associates and subsidiaries subject to consolidation.

Separate financial Statements		Consolidated financial statements
Associates	Cost Method or Fair value Method	Equity Method
Subsidiaries		Consolidation

244. From the standpoint of the information providers who prepare the financial statements, the cost method is relatively easier to apply because not enough guidelines are available for the equity method. Not surprisingly, most companies in Korea use the cost method in the separate financial statements. From the standpoint of the information users, however, many concerns have been raised since the cost method applied financial statements do not fully provide the information related to the complicated investment transactions within large business group firms in Korea.

245. According to the recent exposure draft (ED/2013/10), the equity method is permitted as one of the options to account for investments in subsidiaries, joint ventures, and associates in the separate financial statements. Therefore, it is important to examine whether the equity method applied separate financial statements provide value-relevant information to the information users of financial statements.

246. In this paper, we evaluated the usefulness of the equity method by examining the difference in value relevance between the cost method and the equity method. Since the equity method is not allowed under the current K-IFRS in preparing separate financial statements, we extracted the hypothetical book value of equity and net income numbers that could have been available in separate financial statements from consolidated financial statements by using the portion attributable to controlling shareholders. Under K-IFRS, the equity method is to be applied for associates. The following is the method used to calculate the book value of equity (BV) and net income (NI) for the hypothetical equity method applied separate financial statements:

1. Equity method applied separate financial statements' BV = consolidated financial statements'

BV – non-controlling share

2. Equity method applied separate financial statements' NI = consolidated financial statements' NI – non-controlling share

247. By comparing the usefulness of information from the cost method applied separate financial statements with equity method applied separate financial statements, we can provide useful insight concerning whether the equity method is a viable option for preparing the separate financial statements.

248. In addition, we extract the book value of equity and net income of associates from the equity method applied book value of equity and net income of the parent firm as follows:

1. Adj. BV = Equity method applied separate financial statements' BV – Associates' BV
2. Adj. NI = Equity method applied separate financial statements' NI – Associates' NI

249. By examining the differential value relevance of the information about Associates' BV and NI, we can provide additional evidence on the source of value relevance – whether the separate presentation of associates is informative or not. We further investigate under what circumstances the equity method can provide more useful information. The setting we examine in this paper is when investors face different information environments for the associates – whether they are listed or not. We assume that listed companies are more transparent than non-listed companies so that investors evaluate their economic prospects more reliably through publicly available accounting information.

250. This study uses the value relevance research framework originally developed by Ohlson (1995). The value relevance framework assesses how well accounting numbers reflect information used by equity investors by relating market value of equity to the book value of equity and net income. The higher the R-square of the regression model is, the more informative the accounting numbers are to users of accounting information, mostly equity investors. Using this value relevance framework, we can compare the usefulness of the cost method with that of the equity method.

HYPOTHESIS DEVELOPMENT

251. The objective of this study is to evaluate the information content provided by the equity method. To do this, we compare the value relevance of two methods – the cost method vs. the equity method. The baseline model is the value relevance of the cost method. For those parent companies who have associates, we measure the value relevance of the book value of equity and net income by the cost method, as allowed in K-IFRS. We then measure value relevance of the equity method using the hypothetical separate financial statements prepared by the equity method using the information from consolidated financial statements attributable to controlling shareholders. We evaluate the relative value relevance between the cost method and the equity method based on the size of

explanatory power (R-square) from the two methods.

252. The difference between the effect of the cost method applied and the equity method applied separate financial statements is the sum of (1) the effect of equity method applied to associates and (2) the other effects. We first test whether there is an incremental value relevance of the equity method over the cost method using the basic model by Ohlson (1995). Then, we examine whether the effects of (1) and (2) are separately value relevant or not. If they are, then we can provide strong evidence that the equity method provides more useful value relevant information to investors, especially when the information is provided separately. At a minimum, we provide support to give companies an option to use the equity method in preparing their separate financial statements. Since we do not know ex ante the additional value relevance of the equity method over the cost method, we set the following hypotheses in a null form:

Hypothesis 1-1: There is no difference in value relevance between the book value of the equity and net income from the cost method and those from the equity method.

Hypothesis 1-2: There is no difference in value relevance between the book value of the equity and net income from the cost method and those from the equity method regardless of whether the effect of the equity method is presented separately or not.

253. Next, we further investigate whether the information from the equity method provides differential value relevance depending on the associates' listing status. In order to test the differential value relevance by the associates' listing status, we first divide associates into listed companies and non-listed companies, and examine whether the value relevance of the book value of equity and net income of listed associates and those of non-listed associates are different. Since we do not know ex ante whether the equity method applied accounting information of listed associates provides more value relevant information than that of non-listed associates, we set the following hypothesis in a null form:

Hypothesis 2: There exists no difference in value relevance between the book value of equity and net income from listed associates and the book value of equity and net income from non-listed associates.

EMPIRICAL MODELS

254. Based on Ohlson (1995), we test the above hypotheses by using the following regression models.

$$MV_{i,t} = \alpha_0 + \alpha_1 SBV_{i,t} + \alpha_2 SNI_{i,t} + \alpha_3 SBV_{i,t} * LOSS_{i,t} + \alpha_4 SNI_{i,t} * LOSS_{i,t} + IND \text{ Dummies} + \varepsilon_{i,t} \quad (1)$$

$$MV_{i,t} = \beta_0 + \beta_1 CBV_{i,t} + \beta_2 CNI_{i,t} + \beta_3 CBV_{i,t} * LOSS_{i,t} + \beta_4 CNI_{i,t} * LOSS_{i,t} + IND \text{ Dummies} + \varepsilon_{i,t} \quad (2)$$

$$MV_{i,t} = \gamma_0 + \gamma_1 Adj. BV_{i,t} + \gamma_2 Adj. NI_{i,t} + \gamma_3 Adj. BV_{i,t} * LOSS_{i,t} + \gamma_4 Adj. NI_{i,t} * LOSS_{i,t} + \gamma_5 EQBV_{i,t} +$$

$$\gamma_6 \text{EQBV}_{i,t} * \text{LOSS}_{i,t} + \gamma_7 \text{EQNI}_{i,t} + \gamma_8 \text{EQNI}_{i,t} * \text{LOSS}_{i,t} + \text{IND Dummies} + \varepsilon_{i,t} \quad (3)$$

$$\text{MV}_{i,t} = \mu_0 + \mu_1 \text{Adj. BV}_{i,t} + \mu_2 \text{Adj. NI}_{i,t} + \mu_3 \text{Adj. BV}_{i,t} * \text{LOSS}_{i,t} + \mu_4 \text{Adj. NI}_{i,t} * \text{LOSS}_{i,t} + \mu_5 \text{EQBV}_{i,t} + \mu_6 \text{EQBV}_{i,t} * \text{LOSS}_{i,t} + \mu_7 \text{EQNI_P}_{i,t} + \mu_8 \text{EQNI_L}_{i,t} + \gamma_9 \text{EQNI_P}_{i,t} * \text{LOSS}_{i,t} + \mu_{10} \text{EQNI_L}_{i,t} * \text{LOSS}_{i,t} + \text{IND Dummies} + \varepsilon_{i,t} \quad (4)$$

$$\text{MV}_{i,t} = \delta_0 + \delta_1 \text{Adj. BV}_{i,t} + \delta_2 \text{Adj. NI}_{i,t} + \delta_3 \text{Adj. BV}_{i,t} * \text{LOSS}_{i,t} + \delta_4 \text{Adj. NI}_{i,t} * \text{LOSS}_{i,t} + \delta_5 \text{EQBVL}_{i,t} + \delta_6 \text{EQBVL}_{i,t} * \text{LOSS}_{i,t} + \delta_7 \text{EQNIL}_{i,t} + \delta_8 \text{EQNIL}_{i,t} * \text{LOSS}_{i,t} + \delta_9 \text{EQBVNL}_{i,t} + \delta_{10} \text{EQBVNL}_{i,t} * \text{LOSS}_{i,t} + \delta_{11} \text{EQNINL}_{i,t} + \delta_{12} \text{EQNINL}_{i,t} * \text{LOSS}_{i,t} + \text{IND Dummies} + \varepsilon_{i,t} \quad (5)$$

$$\text{MV}_{i,t} = \rho_0 + \rho_1 \text{Adj. BV}_{i,t} + \rho_2 \text{Adj. NI}_{i,t} + \rho_3 \text{Adj. BV}_{i,t} * \text{LOSS}_{i,t} + \rho_4 \text{Adj. NI}_{i,t} * \text{LOSS}_{i,t} + \rho_5 \text{EQBVL}_{i,t} + \rho_6 \text{EQBVL}_{i,t} * \text{LOSS}_{i,t} + \rho_7 \text{EQNIL_P}_{i,t} + \rho_8 \text{EQNIL_L}_{i,t} + \rho_9 \text{EQNIL_P}_{i,t} * \text{LOSS}_{i,t} + \rho_{10} \text{EQNIL_L}_{i,t} * \text{LOSS}_{i,t} + \rho_{11} \text{EQBVNL}_{i,t} + \rho_{12} \text{EQBVNL}_{i,t} * \text{LOSS}_{i,t} + \rho_{13} \text{EQNINL_P}_{i,t} + \rho_{14} \text{EQNINL_L}_{i,t} + \rho_{15} \text{EQNINL_P}_{i,t} * \text{LOSS}_{i,t} + \rho_{16} \text{EQNINL_L}_{i,t} * \text{LOSS}_{i,t} + \text{IND Dummies} + \varepsilon_{i,t} \quad (6)$$

$\text{MV}_{i,t}$:	Market value of equity, end of March at t+1 / beginning total asset
$\text{SBV}_{i,t}$:	BV of equity in separate financial statements at t / beginning total asset
$\text{SNI}_{i,t}$:	NI on separate financial statements at t / beginning total asset
$\text{CBV}_{i,t}$:	BV of controlling shareholders' equity at t/ beginning total asset
$\text{CNI}_{i,t}$:	NI of controlling shareholders at t / beginning total asset
$\text{Adj. BV}_{i,t}$:	(BV of controlling shareholders' equity – Equity method applied BV of equity) at t / beginning total assets
$\text{Adj. NI}_{i,t}$:	(NI of controlling shareholders – Equity method applied NI) at t / beginning total assets
$\text{EQBV}_{i,t}$:	Equity method applied BV at t / beginning total assets
$\text{EQNI}_{i,t}$:	Equity method applied NI at t / beginning total assets
$\text{EQNI_P}_{i,t}$:	Equity method applied Net Profits at t / beginning total assets
$\text{EQNI_L}_{i,t}$:	Equity method applied Net Losses at t / beginning total assets
$\text{EQBVL}_{i,t}$:	Equity method applied BV of equity from listed associates at t / beginning total assets
$\text{EQBVNL}_{i,t}$:	Equity method applied BV of equity From non-listed associates at t / beginning total assets
$\text{EQNIL}_{i,t}$:	Equity method applied NI of listed associates at t / beginning total assets
$\text{EQNIL_P}_{i,t}$:	Equity method applied Net Profits of listed associates at t / beginning total assets
$\text{EQNIL_L}_{i,t}$:	Equity method applied Net Losses of listed associates at t / beginning total assets
$\text{EQNINL}_{i,t}$:	Equity method applied NI of non-listed associates at t / beginning total assets
$\text{EQNINL_P}_{i,t}$:	Equity method applied Net Profits of non-listed associates at t / beginning total assets
$\text{EQNINL_L}_{i,t}$:	Equity method applied Net Losses of non-listed associates at t / beginning total assets
$\text{LOSS}_{i,t}$:	dummy variable for firms reported net losses
IND Dummies :	industry dummy variables based on the Korean standard industrial classification code

255. In order to test hypothesis 1, we examine the difference in R-squared between Model 1 (the cost method applied book value of equity and net income) and Model 2 (the equity method applied book value of equity and net income). If R-squared of Model 2 is significantly higher than that of Model 1, then we can conclude that the value relevance of the book value of equity and net income by the equity method is greater than that by the cost method.

256. In addition, we examine the difference in R-squared between Model 1 and Model 3 (the equity method book value of equity and net income with associates' book value of equity and net income presented separately). If R-squared of Model 3 is significantly higher than that of Model 1, then we consider that as the evidence that the incremental value relevance of the equity method is driven by the associates. Likewise, If R-squared of Model 4 (the equity method book value of equity and net income with associates' book value of equity and net profits and losses presented separately) is significantly higher than that of Model 1, then we consider that as the evidence on the source of the differential value relevance with respect to net profit/loss of associates.

257. In order to test hypothesis 2, the associates were divided into listed company and non-listed company based on the listing status of the associates. From Model 5, we examine whether there exists differential value relevance of the equity method depending on the listing status of the associates. If the coefficients δ_5 and δ_9 as well as δ_7 and δ_{11} are statistically different, then it provides evidence that the listing status provides differential value relevance to the users of accounting information of firms that applied the equity method. From model 6, we further investigate the source of differential value relevance with respect to net profit/loss of associates.

SAMPLE SELECTION

258. Our sample is selected using the following criteria.

1. Firms are listed in Korea Exchanges (KRX) for the years 2011 and 2012 whose fiscal year ended in December and they filed consolidated financial statements.
2. Firms are in non-financial sectors.
3. All necessary financial and accounting data are available from KIS-VALUE and Fn-Guide.

259. In order to classify associate firms into two groups, listed and non-listed, depending on the listing status of associates, we hand-collected data on associates from the notes of the financial statements. Listed firms are defined as the firms listed in the major Korean stock exchange (KRX), while non-listed firms are all others including over-the-counter (OTC) firms and foreign firms.

RESULTS

260. First, we test Hypothesis 1-1 by comparing the value relevance of the cost method and the equity method based on the R-squares of Model 1 and Model 2. The result is shown in the first and the second columns of Table 5-1. We find that the coefficients on book value of equity (SBV and CBV) and net income (SNI and CNI) are all positive and significant in both the cost method and the equity method applied in separate financial statements.

261. More importantly, we find that the R-square of the equity method (Model 2; 52%) is greater than that of the cost method (Model 1; 49%), and the Vuong (1989) test statistic shows that the

difference (3%) is statistically significant at the 1% significance level. This suggests that the equity method applied book value of equity and net income numbers are more useful to users of the information than those of the cost method.

262. Next, we test Hypothesis 1-2 by comparing the value relevance of the cost method and the equity method by adding equity method applied book value of equity and net income of associates as separate regressors in the model by Model 1 and Model 3. The result shows that both equity method applied book value of equity (EQBV) and net income (EQNI) of associates are positive and significant at the 1% significance level, and the R-squared is even higher (Model 3; 54%). This confirms the previous finding that the equity method is more value relevant than the cost method, and it would be more value relevant if the equity method applied book value of equity and net income of associates are provided separately.

263. In addition, we run Model 4 to test whether profit/loss information would provide additional information content to investors or not. The result is shown in the last column of Table 5-1. When we add profit and loss from the equity method separately in the model, only equity method profit variable (EQNI_P) is statistically significant and equity method loss variable (EQNI_L) is not. From this result, we could conclude that the information effect of the equity method net income that is presented in previous Model 3 is mainly driven by profitable associates.

264. Concerning the reason why the information about loss is not value relevant, prior studies suggest “liquidation option hypothesis” meaning that firms have an option to liquidate their investment (e.g., Hayn 1995). In case of associates with losses, the parent company has an option to liquidate its investments if they are not profitable. Thus, the investors might consider losses of its associates as transient. Accordingly, investors respond to only profitable associates in valuing a parent firm since losses of its associates will not persist. If parent company continues to invest in associates with losses, it indicates that tangible/intangible benefits from the investment in the associates are bigger than the losses. If the losses are significant enough, the company will exercise the liquidating option to prevent additional future losses.

265. Next, we test hypothesis 2 about whether listing status of associates is related to the value relevance of book value of equity and net income by the equity method. The result shows that the difference in the value relevance is present depending on whether the associates are listed or non-listed. More specifically, as shown in the first column of Table 5-2, equity method book value of equity of listed associates (EQBVL) is value relevant (coefficient=0.6807, t-stat=10.48) while that of non-listed (EQBVNL) is not (coefficient=0.092, t-stat=0.25). As to net income, both listed (EQNIL) and non-listed (EQNINL) associates provide value relevant information to investors. Considering those results, listed associates seem to be more value relevant than non-listed associates, which suggests that investors see the information of listed associates as more valuable.

266. Interestingly, the magnitude of the coefficient on net income information is greater for non-listed

associates than listed associates (EQNIL = 2. 6706; EQNINL =6. 3120). This may be due to the fact that information about the non-listed companies is scarce, so investors consider it more salient once it is available. The second column of Table 5-2 shows that profitable associates are value relevant for both listed and non-listed associates. Again, this result supports the liquidation option hypothesis, both in the listed and non-listed companies.

CONCLUSION

267. We find equity method applied financial statements provide more value relevant information than cost method applied financial statements when the parent company has associates. Moreover, when equity method book value of equity of associates and equity method net income of associates are separated from those attributable to the controlling shareholders, the information is even more value relevant. And the additional value relevance seems to be driven by the profitable associates and those associates listed in the stock exchanges. This result suggests that the equity method may provide more value relevant, decision useful information to the users of financial statements, especially when more detailed information about the associates are given separately.

Table 5-1. Comparison of Value relevance between Cost Method vs. Equity Method

	Cost Method Model 1	Equity Method Model 2	Model 3	Model 4
Intercept	0.0640 (1.59)	0.0697 (2.44)*	0.0330 (1.28)	0.0030 (0.05)
SBV	0.6922** (3.41)			
SNI	9.0809** (4.67)			
SBV*LOSS	0.1720 (1.21)			
SNI*LOSS	-10.0806** (-4.93)			
CBV		0.5323* (2.25)		
CNI		7.7906** (6.05)		
CBV*LOSS		0.2395** (10.41)		
CNI*LOSS		-9.4563** (-11.19)		
Adj. BV			0.5842* (2.33)	0.5901* (2.34)
Adj. NI			8.2339** (5.54)	8.2664** (5.45)
Adj. BV*LOSS			0.2612** (15.87)	0.2692** (8.97)
Adj. NI*LOSS			-9.8497** (-8.62)	-9.7967** (-7.76)
EQBV			0.4319** (4.34)	0.4060** (10.09)
EQNI			4.7791** (11.04)	
EQNI_P				5.0311** (23.88)
EQNI_L				6.6057 (1.49)
EQBV*LOSS			0.0179 (0.11)	-0.0297 (-0.27)
EQNI*LOSS			-6.6344** (-42.19)	
EQNI_P*LOSS				-5.9783** (-3.38)
EQNI_L*LOSS				-9.3941** (-3.09)
Industry Dummies	Included	Included	Included	included
R-Squared	0.4943	0.5199	0.5374	0.5385

Table 5-2. Value relevance of Equity Method – Firms with Listed vs. Non-listed Associates

	Model 5		Model 6
	Model 5		Model 6
Intercept	0.0399** (9.56)	Intercept	0.0030 (0.05)
Adj. BV	0.5851* (2.28)	Adj. BV	0.5902* (2.26)
Adj. NI	8.2599** (5.38)	Adj. NI	8.2711** (5.23)
Adj. BV*LOSS	0.2330** (87.23)	Adj. BV*LOSS	0.2398** (42.3)
Adj. NI*LOSS	-9.8653** (-7.71)	Adj. NI*LOSS	-9.8056** (-7.00)
EQBVL	0.6807** (10.48)	EQBVL	0.6745** (10.48)
EQBVNL	0.0692 (0.25)	EQBVNL	-0.0492 -0.53
EQNIL	2.6706** (27.87)	EQNIL_P	2.8035** (37.47)
EQNINL	6.3120** (7.35)	EQNIL_L	2.0495 (1.38)
EQBVL*LOSS	-0.3116 (-1.33)	EQNINL_P	7.4434** (9.84)
EQBVNL*LOSS	0.4717 (1.81)	EQNINL_L	7.4846 1.35
EQNIL*LOSS	-4.7322** (-4.8)	EQBVL*LOSS	-0.3698* (-2.57)
EQNINL*LOSS	-9.4212** (-4.16)	EQBVNL*LOSS	0.6751** -3.44
		EQNIL_P*LOSS	-0.2408 (-0.17)
		EQNIL_L*LOSS	-4.9927** (-3.13)
		EQNINL_P*LOSS	-11.2020** (-7.00)
		EQNINL_L*LOSS	-10.6855** (-9.02)
Industry Dummies	Included	Industry Dummies	included
R-Squared	0.5418	R-Squared	0.5440

CHAPTER 6 SUMMARY AND CONCLUSION

268. There has been practical diversity in applying the equity method of IAS 28 to an actual transaction. Lack of specific guidance can be one of the reasons for the practical diversity. But the radical cause of the diversity in practice lies in the fact that the concept of the equity method has not been clearly defined. Due to this vagueness of the concept of the equity method, even the IASB, a standard setter, released the ED which is inconsistent with the existing standard.

269. Therefore, the IASB's equity method research project must focus on providing a clarification of the concept of the equity method. Once the concept of the equity method has been established, it is expected that the other applicable issues will fall into place.

SUMMARY OF THIS REPORT

270. This report was created to find and inform the IASB about the issues that should be included in the future amendments of IAS 28 and to present a practicable direction for resolving the issues. Specifically, this report includes the following:

271. First, we have reviewed the history of the equity method, and compared the equity method accounting standards among Germany, the USA and Korea. In this process, we have closely examined what has been considered as the concept of equity method and upon what concept of equity method various jurisdictions' standards on the equity method were based. From the history of the equity method, we came to learn that there have always been disputes related to the equity method; specifically between the idea of it serving as one-line consolidation and measurement basis. It was also confirmed that, to this day, there is no agreement or general consensus on what should be the concept of the equity method. Because a consensus still has not been agreed upon between the two concepts, not only the IAS 28 but also the equity method accounting standards of Germany, the USA and Korea were found to be a mixture of the two concepts without any sound reasoning.

272. Secondly, therefore, this paper attempts to provide internally consistent concepts of the equity method. It should, however, be noted that we did not try to develop the concept of the equity method by the traditional viewpoints of one-line consolidation and measurement basis. Instead, we introduced three alternative concepts of the equity method by using a new dimension called "scope of equity-accounted group." Alternative 1 regards the investee as a part of the equity-accounted group. It assumes that the investor directly holds the total assets and liabilities of the investees. Alternative 2 regards only the investor's share of the investee as a part of the equity-accounted group. Therefore, under this concept, only the invested share of the investee's assets and liabilities is considered to be held by the investor. In contrast, Alternative 3 does not view the investee as a part of an equity-accounted group, and thus the investee's assets and liabilities are not assumed to be held by the investor. In this paper, we presented how equity method accounting could differ under the three alternative concepts. In the process of comparing the alternatives, we also were

able to confirm that current IAS 28 has numerous unresolved inconsistencies within.

273. The three alternatives that are presented in this paper should be considered as a meaningful attempt because they are not based on the existing concepts such as one-line consolidation or measurement basis but on the scope of equity-accounted group. As a result, we were able to present alternatives similar to the existing concepts of the equity method. Alternative 1 and Alternative 3 can be viewed to be consistent with one-line-consolidation and measurement basis, respectively. Alternate 2 can be viewed as a mixture of one-line consolidation and measurement basis but without any inconsistencies within.

274. Thirdly, we have addressed additional issues that need to be considered by the IASB upon carrying out the research project on the equity method. Especially, based on the experiences of Korea, we have listed the expected issues when the equity method is allowed in the separate financial statements. Since 1998 until 2011 when IFRS was adopted, Korean firms were mandatorily required to apply the equity method in their stand-alone financial statements. Therefore, Korea has accumulated abundant experiences of resolving issues that have taken place in applying the equity method to the stand-alone financial statements. This paper does not enclose issues that are considered to be extremely technical. However, we can share those issues with the IASB upon the IASB's request.

275. Lastly, by testing the equity method's value relevance using the market-based research methodology, we were able to confirm that the information users on the market consider the information provided by the equity method very valuable. If the information users think that the information provided by the equity method is useless, there would be no reason to worry about the equity method. However, upon discovering that the information users consider this information valuable, we once again confirmed that equity method accounting is important and that more time and effort need to be invested to develop a better equity method accounting standard.

ADDITIONAL ISSUES TO BE CONSIDERED

276. In this report, we showed that the new dimension, i.e., the scope of equity-accounted group, may be used to create at least three internally-consistent alternative accounting standards on the equity method. With regard to this, the IASB needs to thoroughly consider and assess what other dimensions are available other than the scope of equity-accounted group. The IASB needs to deliberate about what additional alternative concepts are available based on different dimensions.

277. In this report, we did not attempt to judge which of the alternatives would serve as the best option. The judgment could be based upon various interested parties' opinions and discussions. But, we believe that in order to make the correct judgment, before looking for the opinions of various interest parties, the IASB needs to start research on the following issues:

278. First of all, the IASB needs to clearly define the assets subject to the equity method (i.e., equity-accounted investments) and their characteristics. This is important for two reasons. One is that, only when we define what the key characteristics of these assets are and provide reasoning on why and how these assets are distinguished from other similar assets, we can justify why the equity method should be applied to the equity-accounted investments. Two, the clear definition of the assets subject to the equity method and their characteristics should help the IASB judge which concept of the equity method and which equity method accounting faithfully represents the equity-accounted investments.
279. Currently, we use the concept of “significant influence” and “20% rule” to define the assets subject to the equity method. However, we still do not share a clear understanding on what is significant influence and how it is different from the concept of “control.” Moreover, according to Nobes (2002), the 20% rule does not have any logical basis of reasoning whatsoever. Therefore, we suggest the IASB clearly define what is an equity-accounted investment. Without a clear definition, it would never be possible to judge which concept of the equity method and which equity method accounting faithfully represents the equity-accounted investments.
280. When contemplating on this issue, the IASB need not to select only one between the one-line consolidation and the measurement basis. As we have suggested in this report, the IASB should try to develop other dimensions such as the scope of equity-accounted group.
281. In addition to the above contemplation, we believe, the IASB needs to explore whether the equity method is absolutely necessary. Resultant of such research, the IASB may reach the conclusion that special accounting such as equity method may not be necessary to represent significant influence or joint venture in the financial statements. More specifically, under the historical cost-based accounting, the equity method was able to provide relevant information. However, we may need to contemplate whether the equity method accounting also provides relevant information under the fair value-based accounting. For example, the equity method would not be able to provide relevant information any more when equity method applicable investment has an active market (i.e., level 1 inputs of the fair value hierarchy).
282. The IASB’s equity method research project should start from contemplating on these underlying problems.

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APPENDIX 1: ADDITIONAL CONSIDERATIONS ON ELIMINATIONS OF TRANSACTION WITH ITS ASSOCIATE

If the IASB's project on the equity method concludes that effects of the transaction with an associate should be eliminated, there are additional issues to be addressed.

ADDITIONAL ISSUE 1: TYPE OF TRANSACTION TO BE ELIMINATED

1. Paragraph 28 of IAS 28 requires the elimination of gains and losses resulting from downstream or upstream transactions. Only with these requirements, it is not clear whether the interest income or interest expense that occurs from transactions between the investor and its associate needs to be eliminated. As a result, the diversity in practice exists on whether to eliminate those interest income and interest expense when applying the equity method. Accounting firms also take different views on this issue.³¹
2. Alternatives 1 and 2 developed in Chapter 3 require the effects of transactions with associates to be eliminated. This requirement is based on the view that an entire transaction or a portion of the transaction with an associate is a transaction within an equity-accounted group.

ADDITIONAL ISSUE 2: ELIMINATION OF BALANCES

3. Another issue that needs to be considered with regards to eliminating the effects of transaction with an associate is whether to eliminate the balances of the assets and liabilities resulted from the transaction with an associate.
4. The current IAS 28 only requires the elimination of profit and loss occurred from transactions with associates and therefore, it is understood that the related balances such as receivables are not subject to be eliminated. In accordance with this requirement, the illustrative examples in Chapter 3 do not adjust balances of assets and liabilities related to the transactions. However, Alternative 1 and 2 views the transaction, whether entirely or in part, as a transaction within an equity-accounted group. Therefore, under Alternative 1 and 2, it is reasonable for the balance of related assets and liabilities to be eliminated as well.
5. However, elimination of the related balances has a ramification. Let us take another look at Example 3.5 to understand the effects of the elimination. In Example 3.5, elimination of the entire effects of the transaction would be done through the following entries.

Alternative 1

³¹ KPMG and Deloitte interpret whether or not to eliminate the interest income and interest expense depends upon an entity's accounting policy, while EY does not see it as a subject of elimination.

DEBIT		CREDIT	
Sales	1,000	Account receivable	1,000
Inventories	500	Cost of sales	500

Alternative 2

DEBIT		CREDIT	
Sales	200	Account receivable	200
Inventories	100	Cost of sales	100

6. As a result of these entries, the account receivable that was obtained from the sales of inventory is derecognized and inventories that were sold is recognized again. In other words, the equity method has an impact on not only the equity accounted investment but also the recognition and measurement of related other assets and liabilities.

ADDITIONAL ISSUE 3: ITEMS AGAINST WHICH THE ELIMINATION IS MADE

7. Another issue is which item should be adjusted in eliminating the effects of a transaction with an associate. This could be done by adjusting equity-accounted investments or by directly adjusting internal transactions. In Example 3.5, when eliminating the effect of a downstream inventory sale, sales and cost of sales are eliminated and this method is coherent with Alternative 1 or 2.
8. However, effects of the elimination are sometimes recognized as profit or loss when the equity method is used in practice. In applying this approach, the effects of the transaction are eliminated by recognizing profit or loss using the equity method, as in the following entries.

Alternative 1

DEBIT		CREDIT	
Equity method net income	500	Equity-accounted investments	500

Alternative 2

DEBIT		CREDIT	
Equity method net income	100	Equity-accounted investments	100

ADDITIONAL ISSUE 4: ELIMINATION IN EXCESS OF THE CARRYING AMOUNT OF THE INVESTMENT

9. In eliminating gains from a downstream transaction, the amount to be eliminated may exceed the carrying amount of the equity-accounted investment. In this case, Alternative 1 and 2 require the investor to recognize liabilities by the amount that exceeds the carrying amount of the investment. However, concerns exist regarding whether the liability meets the definition of a liability under the Conceptual Framework.

APPENDIX 2: SUMMARY OF COMMENT LETTERS FROM CONSTITUENTS

1. We have received comment letters on this report from six constituents since we released the report on June 2014. The six constituents are:

Australian Accounting Standards Board (AASB)

European Financial Reporting Advisory Group (EFRAG)

Institute of Chartered Accountant of Pakistan (ICAP)

Mexican Financial Reporting Standards Board

New Zealand Accounting Standards Board

South African Financial Reporting Standards Committee and Institute of Chartered Accountants (FRSC and SAICA)

2. Comment letters are attached to this report at Appendix 3. Appendix 2 summarizes these comment letters.

GENERAL COMMENTS ON THE CONCEPTUAL BASIS OF THE EQUITY METHOD

3. 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.
4. However, not all constituents agree with the dimension proposed in this report, which is the scope of equity-accounted group.
 - 4.1. Three constituents support our approach of considering the scope of equity-accounted group. They are NZ Accounting Standards Board, EFRAG, and Mexican Financial Reporting Standards Board. NZ Accounting Standards Board noted further that when considering the scope of equity-accounted group, the conceptual basis for the equity method needs to be considered in the context of the IASB's Conceptual Framework project, in particular, the reporting entity concept and its relationship with the definition of an asset. EFRAG proposes a new term, *boundaries of economic activities*, for the scope of equity-accounted group.
 - 4.2. The FRSC and the SAICA see the equity method as a measurement approach. FRSC and SAICA further noted that, if the equity method is considered to be a measurement basis, it should be studied whether the equity method should be regarded as an alternative measurement basis which should be included in IFRS 9.
 - 4.3. AASB is not different from the FRSC and the SAICA in seeing the equity method as a

measurement approach. However, the viewpoint of AASB is more extreme. AASB mentions, “the equity method potentially could be applied only as a surrogate for fair value.” Therefore, AASB proposes to remove the equity method from IFRSs. AASB thinks it would simplify the requirements of IFRSs and improve the general purpose financial statements by consolidating subsidiaries only in the consolidated financial statements and measuring investments in other entities at cost or fair value.

4.4. ICAP’s comment is rather peculiar. ICAP proposes dual approach; the measurement basis is used by preparers of single company financial statements, while the consolidation basis is used for presenting information of a group accounting structure.

COMMENTS ON SPECIFIC QUESTIONS INCLUDED IN THE REPORT

5. The followings are the questions included in this report, and the responses of the constituents to those questions.

1.1 In Korea, associates take up a significant portion of financial statements. Please provide us with the following ratios of your jurisdiction.

- (a) The proportion of the carrying value of equity-accounted investments for associates, compared to total assets of consolidated financial statements
- (b) The proportion of the equity method net income from associates, compared to the total net income of consolidated financial statements
- (c) The proportion of the equity method net income from associates, compared to the total net income of separate financial statements

1.2. In Korea, the effect of the equity method net income from subsidiaries on the financial statements is more significant than that from associates. Please provide us with the following ratios of your jurisdiction.

- (a) The proportion of the carrying value of equity-accounted investments for subsidiaries, compared to total assets of consolidated financial statements
- (b) The proportion of the equity method net income from subsidiaries, compared to the consolidated total net income
- (c) The proportion of the equity method net income from subsidiaries, compared to the parent’s net income in the separate financial statements

For the calculation of the proportions, please use absolute values. If you do not have reliable data for the calculation, please provide us with your best estimation.

- AASB: Not available.
- EFRAG: Not available.

- ICAP: Not available.
- Mexican Financial Reporting Standards Board: Statistical data is not available. However, in Mexico, the extent of investments on associates is not significant while the extent of investment on subsidiaries is.
- NZ Accounting Standards Board: The data of the 50 largest and most liquid companies listed on the New Zealand Stock Exchange showed that the extent of equity-accounted investments in New Zealand is significantly less than in South Korea.
- FRSC and SAICA: Statistical data is not available, but FRSC and SAICA believe that associates make up a significant portion of financial statements in South Africa.

1.3 Has your jurisdiction used the equity method on the stand-alone financial statements? If yes, please provide us with the year when you started using it and, if stopped, the year when you stopped using it.

- AASB: AAS 14 *Equity Method of Accounting*, which was issued in 1983 and applied from 31 March 1984 required the application of the equity method to associates in “equity supplementary financial statements”, which were additional to the investor’s own financial statements as a legal entity and the consolidated financial statements. AAS 14/AASB 1016 *Accounting for Investments in Associates* were re-issued/issued in 1997, to apply from 30 June 1998. These Standards required the equity method of accounting to be applied in the consolidated financial statements. The equity method was not permitted in the investor’s own financial statements.
- EFRAG: No comment.
- ICAP: No comment.
- Mexican Financial Reporting Standards Board: Mexico has always used the equity method to account for associates, subsidiaries and joint ventures in separate financial statements.
- NZ Accounting Standards Board: The equity method has not been used in the stand-alone financial statements.
- FRSC and SAICA: No comment.

3.1 In the past, the concept of equity method contrasted between the concept of one-line consolidation and measurement basis. This report suggests three alternative concepts of equity method based on a new dimension, the scope of group. Do you think a scope of group is an appropriate dimension? Do you agree with this concept? If not, please explain.

3.2 Do you think that there are other dimensions to establish the concept of the equity method?

- AASB: Do not agree. AASB sees the equity method as a measurement approach. The equity method potentially could be applied only as a surrogate for fair value.
- EFRAG: Agree. But the term 'group', which is used for the scope of equity-accounted group, could be confused with the group, which is being used by IFRSs in defining control. Thus, EFRAG proposes a new term, *boundaries of economic activities*, for the scope of equity-accounted group. EFRAG also proposes the 'features' that could potentially affect the scope of equity-accounted group. They are (a) the extent to which an investee's economic activities are an integral part of the investor's economic activities, and (b) the business model of the investor (for example, an investment entity parent will have a different business purpose from an operating entity parent).
- ICAP: Do not agree. Instead, ICAP proposes dual approach; the measurement basis is used by preparers of single company financial statements, while the consolidation basis is used for presenting information of a group accounting structure.
- Mexican Financial Reporting Standards Board: Agree. Mexican Financial Reporting Standards Board believe that Alternative 2 is the most appropriate approach to be used.
- NZ Accounting Standards Board: Agree. NZ Accounting Standards Board noted further that when considering the scope of equity-accounted group, the conceptual basis for the equity method needs to be considered in the context of the IASB's Conceptual Framework project, in particular, the reporting entity concept and its relationship with the definition of an asset.
- FRSC and SAICA: Do not agree. The FRSC and the SAICA see equity method as a measurement approach. FRSC and SAICA further noted that, if the equity method is considered to be a measurement basis, it should be studied whether the equity method should be regarded as an alternative measurement basis which should be included in IFRS 9.

4.1 This paper includes the practical issues which are not defined or unclearly stated in IAS 28 (2011). Do you agree that the issues should be defined or more clearly stated in IAS 28 (2011)? If not, please explain.

- AASB: No comment.
- EFRAG: Agree that there are practical issues that are not defined or are unclearly stated in IAS 28 (2011). It would be helpful if these issues were addressed or more clearly stated.
- ICAP: Agree with the issues described in this report. These issues should be clarified in IAS 28.
- Mexican Financial Reporting Standards Board: No comments.
- NZ Accounting Standards Board: No comment.
- FRSC and SAICA: Agree with the issues described in this report.

4.2 Are there additional accounting treatments that IAS 28 needs to consider but are not addressed in this paper? If so, which additional issue needs to be addressed?

- AASB: No comment.
- EFRAG: Responses from constituents to the EFRAG Short Discussion Series Paper also identified the following issues: (a) contingent consideration arrangements, (b) impairment testing, (c) acquisitions carried out in stages, (d) deferred taxes, and (e) the challenge in obtaining sufficient information necessary to apply the equity method of accounting.
- ICAP: Not aware of any other issues.
- Mexican Financial Reporting Standards Board: No comments.
- NZ Accounting Standards Board: No comment.
- FRSC and SAICA: Coverage of the practical issues of the equity method is extensive.

4.3 K-GAAP regulates different equity methods for associates and subsidiaries on stand-alone financial statements. Does your jurisdiction have the same experience as Korea?

- AASB: No comment.
- EFRAG: Not available.
- ICAP: No experience.
- Mexican Financial Reporting Standards Board: Has the same experience. As under K-GAAP, MFRS require different equity methods for associates and subsidiaries in separate financial statements
- NZ Accounting Standards Board: No experience.
- FRSC and SAICA: No experience.

4.4 Do you agree with distinguishing the equity method for subsidiaries from that for associates? Please explain.

- AASB: No comment.
- EFRAG: Do not agree for three reasons; (1) separate financial statements have a different role in financial reporting than consolidated financial statements, (2) since investments in subsidiaries and associates are both recognised as investments In separate financial statements, the accounting requirements should be similar, and (3) having more than one method of accounting called the equity method would be confusing in practice.

- ICAP: Do not agree. ICAP proposes the dual approach.
- Mexican Financial Reporting Standards Board: Agree.
- NZ Accounting Standards Board: No comment.
- FRSC and SAICA: Do not agree if the method is used as a consolidation basis. However, if the equity method is a valuation basis, this option should be available to stand-alone financial statements for valuation of the investments in subsidiaries.

APPENDIX 3: COMMENT LETTERS FROM CONSTITUENTS



Australian Government
Australian Accounting
Standards Board

Level 7, 600 Bourke Street
MELBOURNE VIC 3000
Postal Address
PO Box 204
Collins Street West VIC 8007
Telephone: (03) 9617 7600
Facsimile: (03) 9617 7608

15 September 2014

Mr Ji-Hun Park
Assistant Technical Manager
Korea Accounting Standards Board
KCCI Building, 4th Floor
39 Sejong-daero, Jung-gu
Seoul 100-743
SOUTH KOREA

Dear Mr Park,

The Equity Method
KASB Discussion Paper No. 18

The staff of the Australian Accounting Standards Board are pleased to respond to the Korea Accounting Standards Board on the Discussion Paper (DP).

Since 2005, Australian Accounting Standards have incorporated International Financial Reporting Standards (IFRSs) of the International Accounting Standards Board, for application by both for-profit entities and not-for-profit entities, whether in the private sector or the public sector. Publicly accountable for-profit private sector entities complying with Australian Accounting Standards will also comply with IFRSs. Not-for-profit entities and public sector entities complying with Australian Accounting Standards might not comply with IFRSs if any Australian modifications for such entities are applied.

The Equity Method of Accounting in Australia

We have not specifically researched the prevalence of the equity method of accounting in general purpose financial statements of Australian entities. The present Standard, AASB 128 *Investments in Associates and Joint Ventures*, incorporates the current IAS 28. Prior to the adoption of IFRSs in 2005, Australian Accounting Standards included requirements for the application of the equity method of accounting to interests in associates, as set out below.

The first Standard, AAS 14 *Equity Method of Accounting*, was issued in 1983 and applied from 31 March 1984. It required the application of the equity method of accounting to interests in associates in “equity supplementary financial statements”, which were additional to the investor’s own financial statements as a legal entity and the consolidated financial statements. This was due to a perceived legal impediment in Australia that prevented the inclusion in consolidated financial statements of information that did not already exist in the accounts of the entities in the group (defined as a parent and its subsidiaries), since associates were outside the group. AAS 14 did not permit application of the equity method in the investor’s own financial statements.

When the legal impediment was finally removed, AAS 14/AASB 1016 *Accounting for Investments in Associates* were re-issued/issued in 1997, to apply from 30 June 1998. These Standards required the equity method of accounting to be applied in the consolidated financial statements. The equity method was not permitted in the investor's own financial statements.

A Basis for the Equity Method of Accounting?

The AASB staff agree with the comments in the DP that the equity method of accounting might be seen in some respects as a one-line consolidation technique and in other respects as a measurement basis for investments in other entities. We also appreciate the efforts made in the DP to set out consistent approaches to accounting issues arising in the application of the equity method based on the three “scope of group” alternatives.

However, we do not think any of the scope of group alternatives would provide a conceptual basis for the equity method. IFRSs already include the notion of a group of entities, defined as a parent and its subsidiaries, which are the entities controlled by the parent. We do not think it would be helpful to introduce into IFRSs a different scope of the group solely for the purpose of providing a basis for the equity method.

In our view, the only appropriate consolidation process for controlled entities is the line-by-line consolidation process set out in IFRS 10 *Consolidated Financial Statements*. Accordingly, we do not support applying the equity method to subsidiaries, as they should be fully consolidated in financial statements for the group. As is noted in the DP, the purpose of separate financial statements that incorporate interests in subsidiaries through the equity method of accounting is unclear, and confusing in relation to consolidated financial statements.

Furthermore, a one-line consolidation is not appropriate for interests in associates. As the investor does not control the associate, the investor should account for its interest in the associate as an investment. The equity method under this approach is a measurement approach, as identified under Alternative 3 in the DP. The main measurement bases already set out in IFRSs for investments in non-controlled entities are cost or fair value. As the equity method is inconsistent with cost measurement, the equity method potentially could be applied only as a surrogate for fair value. In our view, the equity method would only rarely be the best available approach for measuring fair value of such investments.

Is the Equity Method Needed?

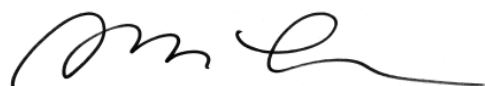
Empirical research may have concluded that the equity method of accounting provides useful information to users of general purpose financial statements. However, this assessment might be based on comparing the equity method with the cost method (see paragraph 16.4 of the DP). The DP also suggests, in paragraph 235, that the equity method in application to subsidiaries has no incremental value in comparison with consolidated financial statements. A helpful question to research would be to compare the usefulness of equity accounting measurement and fair value measurement of investments in associates.

The view of the AASB staff is that the numerous issues in applying the equity method could be avoided by removing the equity method from IFRSs. This would simplify the requirements of IFRSs and improve the general purpose financial statements by

consolidating subsidiaries only in the consolidated financial statements and measuring investments in other entities at cost or fair value. Under this approach, the equity method of accounting would not be needed.

If you have any questions regarding any matters in this letter, please contact Clark Anstis (canstis@asb.gov.au).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Angus Thomson', with a long horizontal flourish extending to the right.

Angus Thomson
Director of Research

5 September 2014

Korea Accounting Standards Board
KCCI Building 4th Flr.
39, Sejongdaero, Jung-gu
Seoul 100-743
South Korea

Dear Sir/Madam,

Re: Discussion Paper No 18 - *The Equity Method*

On behalf of the staff of the European Financial Reporting Advisory Group ('EFRAG staff'), I am writing to comment on the Discussion Paper *The Equity Method*, issued by the KASB on 30 June 2014 ('the DP'). This letter is intended to contribute to the KASB's due process and to the global discussion on the role of the equity method of accounting.

This letter has been prepared by the EFRAG staff and the responses to the questions in the DP are the views of the EFRAG staff. To the extent possible, these views are informed by previous EFRAG work on the topic. However, the comments have not been subject to the EFRAG due process or approved by EFRAG's Technical Expert Group. It therefore does not necessarily indicate the conclusions that would be reached by EFRAG after full deliberation and public consultation.

EFRAG staff welcomes the DP and we are delighted to respond to it: we believe research papers such as this are important in developing high quality solutions to difficult conceptual issues.

Overall, EFRAG staff agrees with the basic premise of the DP, that the boundaries of economic activities of a reporting entity are not limited to the notion of control. Our main comments can be summarised as follows:

- (a) We believe the term 'economic activities' would more accurately describe the boundaries of the activities included in the financial statements of a reporting entity, and be less confusing than referring to 'group'.
- (b) Given that the notion of 'group' or 'economic activity' is central to the DP and the alternatives it discusses, we believe it is would be worthwhile exploring this notion further in developing a sound conceptual basis for the equity method and what it aims to portray.
- (c) We believe there are issues that would benefit from further research work in developing a satisfactory solution to address the issues around the equity method.

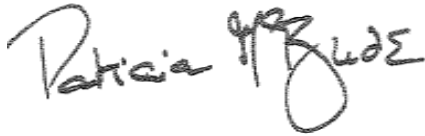
EFRAG published a Short Discussion Series Paper *The Equity Method: a measurement basis or one-line consolidation?* in January 2014 which considered if clarification of the underlying principles of the equity method could assist in reducing diversity in practice and the frequency of minor amendments to IAS 28 *Investments in Associates and Joint Ventures*. That paper is attached and the comment letters are available on the paper's [project page](#) on the EFRAG website.

KASB Discussion Paper: The Equity Method
EFRAG Staff response

In writing this response we have focused on those areas where we believe we can add value. In the Appendix we have provided some general comments we believe are pertinent as well as answering the questions raised in the DP.

If you would like to discuss our comments further, please do not hesitate to contact Isabel Batista, Benjamin Reilly or me.

Yours faithfully,

A handwritten signature in black ink, appearing to read "Patricia McBride". The signature is stylized with a large, looped "P" and a cursive "McBride".

Patricia McBride
EFRAG Technical Director

APPENDIX

General comments

The Problem Space

- 1 EFRAG staff agrees with the basic premise of the DP that the boundaries of economic activities of a reporting entity are not solely limited to the 'group' as determined by control. There is currently a gap between the conceptual thinking for activities controlled by the reporting entity (depicted by consolidation), and those activities over which the reporting entity has no, negligible or limited influence. This conceptual gap is the Problem Space needing to be addressed and the DP makes a good contribution to doing so by examining whether the 'scope of group' could be used as a 'new dimension' to account for investees that are within the Problem Space. We agree that such an approach is a good starting point for further research. We depict these relationships below.

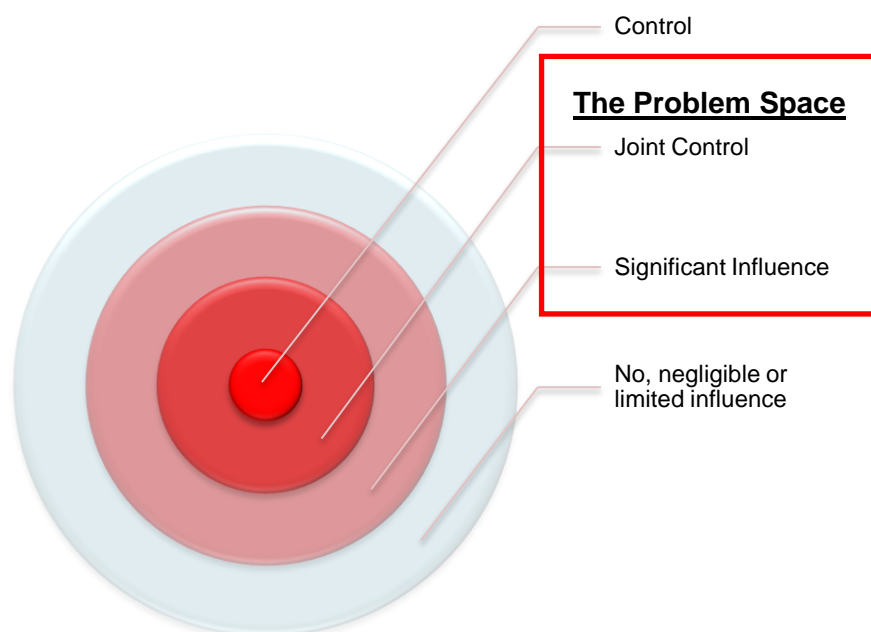


Figure 1 – Scope of economic activities showing the Problem Space

- 2 IASB Exposure Draft ED/2010/2 *The Conceptual Framework for Financial Reporting: The Reporting Entity* ('the Reporting Entity ED') stated that 'Identifying a reporting entity in a specific situation requires consideration of the boundary of the economic activities that are being conducted, have been conducted or will be conducted.'
- 3 For activities controlled by the reporting entity, the boundaries of the reporting entity (in consolidated financial statements) are set so that the activities are fully included (that is, they are consolidated) at the level of the assets and liabilities. In other words, the unit of account is driven by the assets and liabilities that comprise an investment, rather than the investment as a single unit of account.
- 4 The Reporting Entity ED made no specific proposals regarding the boundaries of economic activities to be included when the reporting entity can jointly control or significantly influence certain economic activities without controlling them.

- 5 The depiction of value creation through activities (and companies/entities) in this Problem Space is an important area for financial reporting. We support the idea of formally defining a scope of economic activities to be included in the financial statements for a reporting entity with respect to these, and it should assist with standard-setting activity. However, we do not consider that the equity method of accounting is the only method that could be considered in determining how to reflect these entities in the scope of economic activities.
- 6 In our view, it is important to understand what it is the application of the equity method¹ of accounting seeks to portray and what financial reporting issues it seeks to resolve. As discussed below, it is necessary to determine the scope of economic activities and its implications. For example, does the relationship between investor and investee affect transactions between these parties and should the effect of these transactions be wholly or partly eliminated?

Terminology

- 7 The DP proposes a new dimension 'scope of group' to define the underlying concepts of the equity method. In doing so, it proposes to extend the 'scope of the group' to include associates² for two of the three alternatives presented. Paragraph 68 of the DP explains that 'scope of group' can be seen as one of the dimensions to explain the concept of the equity method, based on the relationship between the investor and its associate.
- 8 We agree with the description in paragraph 68 of the DP of "a single economic entity" consisting of an investor and its associate", but believe this more accurately describes the *boundaries of economic activities* included in the financial statements of the reporting entity rather than delineating a 'group'. The word 'group' has a specific definition in IFRSs and using the word otherwise has the potential to cause confusion.
- 9 As such, and consistently with the Reporting Entity ED, we prefer to use the term 'economic activities', which also reflects the fact that the equity method of accounting may be used for purposes other than in the consolidated financial statements. The different proposals in the DP, in our view, relate to different 'scopes of economic activities' that are included in the financial statements of a reporting entity.

Scope of economic activities

- 10 Although the equity method is currently used in IFRSs (in consolidated financial statements) for depicting value creation in this Problem Space, this is a result of standard-setting decisions: other presentations are possible. The concept of scope of economic activities could equally be used as an underlying principle for other ways of presenting value creation such as proportionate consolidation (as in former IAS 31 *Interests in Joint Ventures*) or the gross-equity method (as in UK GAAP FRS 9 *Associates and Joint Ventures*).
- 11 We also note that, although the equity method of accounting currently covers investees that are both jointly controlled and significantly influenced there is no

¹ Under existing IFRS associates and joint ventures are accounted for under the equity method.

² Consistently with the DP, in this letter we use 'associate' to mean an associate or joint venture accounted for using the equity method.

KASB Discussion Paper: The Equity Method
EFRAF Staff response

conceptual reason why these should be subject to the same reporting requirements. A different scope of economic activity, and different reporting requirements, could be chosen for each of these different relationships.

- 12 EFRAF staff believes that there is a fundamental question about which investments should (or should not) be part of 'scope of economic activities' that needs to be addressed in order to develop a conceptual basis to report investees in the Problem Space. It is possible that expanding the scope of economic activities would lead to different conclusions about what should be included – it would not necessarily be limited to the existing classification of associates.
- 13 As a contribution to the DP, we have thought about the 'features' that could potentially affect the scope of economic activities and whether the control, joint control or significant influence relationship between the investor and investee is the best basis for determining this scope. Other bases that could be used to define the scope of economic activities include:
 - (a) the extent to which an investee's economic activities are an integral part of the investor's economic activities; and
 - (b) the business model of the investor (for example, an investment entity parent will have a different business purpose from an operating entity parent).

Issues for further research

- 14 We have identified a number of areas that would benefit from further research in order to address issues around the concept of the equity method and what it aims to portray and resolve in terms of accounting issues. These are:
 - (a) definition of economic activities;
 - (b) scope of economic activities and the appropriate basis to determine this scope;
 - (c) accounting implications when an investee is not considered to be a business; and
 - (d) unit of account pertaining to an investment in an investee (individual assets and liabilities versus an investment as a whole).

Chapter 1

Question

1.1 In Korea, associates take up a significant portion of financial statements. Please provide us with the following ratios of your jurisdiction.

- (a) The proportion of the carrying value of equity-accounted investments for associates, compared to total assets of consolidated financial statements
- (b) The proportion of the equity method net income from associates, compared to the total net income of consolidated financial statements
- (c) The proportion of the equity method net income from associates, compared to the total net income of separate financial statements

1.2. In Korea, the effect of the equity method net income from subsidiaries on the financial statements is more significant than that from associates. Please provide us with the following ratios of your jurisdiction.

- (a) The proportion of the carrying value of equity-accounted investments for subsidiaries, compared to total assets of consolidated financial statements
- (b) The proportion of the equity method net income from subsidiaries, compared to the consolidated total net income
- (c) The proportion of the equity method net income from subsidiaries, compared to the parent's net income in the separate financial statements

For the calculation of the proportions, please use absolute values. If you do not have reliable data for the calculation, please provide us with your best estimation.

1.3 Has your jurisdiction used the equity method on the stand-alone financial statements? If yes, please provide us with the year when you started using it and, if stopped, the year when you stopped using it.

EFRAF staff response

EFRAF staff is not able to respond to questions 1.1 – 1.3.

- 15 We do not have information (or sufficient information) on cross-country application of the equity method of accounting within Europe and therefore are not able to respond to questions 1.1-1.3.

Chapter 3

Question

3.1 In the past, the concept of equity method contrasted between the concept of one-line consolidation and measurement basis. This report suggests three alternative concepts of equity method based on a new dimension, the scope of group. Do you think a scope of group is an appropriate dimension? Do you agree with this concept? If not, please explain.

3.2 Do you think that there are other dimensions to establish the concept of the equity method?

EFRAG staff response

EFRAG staff supports the notion of ‘scope of economic activities’ being used to define the boundaries of information to be included in financial statements.

Within the context of using the equity method of accounting for economic activities in the Problem Space, we do not believe that Alternative 1 would provide useful information. If Alternative 1 were to be used, we have identified an alternative presentation to the equity method that we believe would more faithfully portray this scope of economic activities.

We believe Alternative 2 could be used as a basis for depicting economic activities that are jointly controlled or significantly influenced.

If Alternative 3 were to be used as a measurement basis for financial assets, we believe its appropriate place would be as Level 3 valuation methodology as required by IFRS 13 *Fair Value Measurement*.

- 16 We support the notion of ‘scope of economic activities’ being used as a principle underlying the inclusion in the financial statements of those economic activities in the Problem Space.
- 17 The DP identifies three alternative perspectives that depend on how ‘scope of group’ is defined. Currently IFRS defines a group as a parent and its subsidiaries and all other investees are excluded. Two of the three perspectives in the KASB paper propose that the scope of group includes associates. The DP does not conclude on the most appropriate use of the equity method and therefore does not resolve the underlying question as to whether the equity method is a consolidation technique (in some form) or a measurement basis.
- 18 However, as noted in our general comments, in our view the DP does not clearly articulate why the changes to the scope of economic activities are appropriate and does not explore in depth the implications of such a fundamental change to the definition of a ‘group’ as currently defined in IFRSs. Extending the ‘scope of group’ to include economic activities is likely to lead to different views about this scope, which may not be aligned with the existing classification of associates. Further, we do not think that economic activities in the Problem Space need necessarily be portrayed using the equity method.
- 19 We have specific comments regarding the Alternatives identified in the DP.

Alternative 1

Consolidation methodology

- 20 Paragraph 74 of the DP defines Alternative 1 as 'The investment is accounted for as one-line in the financial statements for the same amount as the net asset value attributable to the investor when an associate is consolidated'.
- 21 We note that consolidation techniques can take a variety of forms and perspectives. Before the 2007 amendments, IAS 27 *Consolidated and Separate Financial Statements* was sometimes described as taking a parent-entity perspective. Following the 2007 amendments, IAS 27 *Separate Financial Statements* and IFRS 10 *Consolidated Financial Statements* have been described as taking an entity perspective. These perspectives are not clearly defined in existing IFRS literature. However IFRSs generally support an entity perspective, such as in part of Phase II of the Business Combinations project.
- 22 Alternative 1 appears to be based on (full) consolidation methodology, similar to IAS 27 (2007) and IFRS 10. This may lead to confusion regarding what it is that alternative 1 is intended to achieve.

Eliminations

- 23 Illustrative example 3.5 shows that, under Alternative 1, elements related to the statement(s) of comprehensive income would be fully eliminated (journal presented under paragraph 126). However, it appears that the investor would still present an asset of CU1000 for accounts receivable – that is, there are no eliminations in respect of the statement of financial position.
- 24 Based on the underlying concept for Alternative 1 we would expect that items would be eliminated from the statement of financial position in the same way as for the statement(s) of comprehensive income. Doing otherwise appears to deviate from treating the whole of the associate as within the 'scope of group'. It also seems contrary to paragraph 82 that notes that transactions with associates are fully eliminated.

Usefulness of information

- 25 We believe that illustrative example 3.5 shows that the value of information provided under Alternative 1 may be limited. This is because any sales made by the investor (and consolidated subsidiaries) to the associate are never reported as revenue (even if the associates subsequently sells the items).
- 26 Revenue is a key performance measure and it is not appropriate for this information to be lost: the presentation of net profit on the transaction within the investments in associate's line item on the face of the statement of financial position is not sufficient. We acknowledge that this problem is not restricted to the proposals in the DP.

Alternative presentation

- 27 We believe that if the scope of economic activities were to be set at the entirety of the associate, then there may be a more appropriate alternative presentation to the Alternative 1 in the DP. This alternative presentation would similarly have a single line representing all of the investee's net assets (that is the shares of the net assets of both the parent's and the owners' outside the reporting entity) and an entry within equity to represent the interests of owners outside the reporting entity. This presentation within equity would be similar to that for Non-controlling Interests in consolidated financial statements.

- 28 Under this alternative approach, the unit of account would be the investment as a whole. This recognises that significant influence or joint control applies at the whole of entity level: the investor has significant influence or joint control over all the activities of the associate and this relationship is not limited to (say) 20% of ownership rights (even though the returns from the relationship may be limited).

Alternative 2

- 29 We believe that Alternative 2 could provide an appropriate conceptual basis for defining the scope of economic activities for associates depicted in the financial statements of the reporting entity (investor). However, as noted above we do not believe that the usefulness of the concept is limited to the equity method.
- 30 A similarly defined scope of economic activities could be used as an underlying concept for 'economic activities' depicted by proportionate consolidation or the gross equity method. Overall, we believe that Alternative 2 could be equally described as a proprietary-perspective one-line consolidation and note that the required procedures (such as partial elimination of gains and losses) are similar to the requirements of IAS 3 *Consolidated Financial Statements*³ (as originally published in 1976).

Eliminations

- 31 One of the reasons why accounting for investees in the Problem Space is an important, and very difficult, area is that the nature, extent and pricing of transactions may reflect a variety of considerations not present with unrelated parties. Although similar considerations may be present in transactions with related parties that are not associates or subsidiaries, these are addressed through disclosure alone.
- 32 For related parties that are associates, disclosure alone may not be sufficient for the appropriate depiction of economic activities. This is because the returns to the investor from its investment may depend, in whole or in part, on its own transactions with the investee.
- 33 Given that IFRSs are based on a mixed measurement model and that Profit or Loss is agreed to be a key measure of an entity's performance, it is important that any income or expense from transactions with an associate, and which will contribute to returns on the investment, are recognised at an appropriate time. For transactions with consolidated entities, these eliminations (such as the investee's profit included in the 'cost' of an item of property, plant and equipment purchased by the investor from the investee) are carried out at the level of each individual line item. For equity-accounted investees under IAS 28, income and expense are recognised in the appropriate period by partially eliminating gains or losses within the measurement of the investee.
- 34 As noted in our comments on Alternative 1, useful information may be lost by fully eliminating all transactions. We therefore believe that Alternative 2 could present a useful conceptual basis for the appropriate depiction of value creation through associates by using partial eliminations.

³ It is also worth noting that the accounting requirements for the equity method were contained within IAS 3. Therefore when the equity method first appeared in International Accounting Standards the requirements were for a proprietary-perspective consolidation presented in a single line.

Acquisition of additional interests

- 35 We note that Table 3-3 *The Application of the Alternatives* states that IFRS 3 *Business Combinations* would apply to the acquisition of additional interests that do not change the status of the investment. We do not believe that this is a necessary consequence of the adoption of Alternative 2. It could potentially be determined that a cost acquisition (and subsequent acquisition) model was appropriate for equity accounted investees.

Alternative 3

- 36 As we understand the DP, under Alternative 3 the equity method would be a measurement basis for financial assets based on the investor's share of the associate's net assets (paragraph 79 of the DP).
- 37 When considering the equity method as solely a measurement basis for an individual asset (the investment), we believe it is important to understand what the equity method is aiming to measure. We have identified three potential purposes:
- (a) depicting the investee's ability to pay dividends to the investor;
 - (b) depicting the special relationship between an investor and an investee in the Problem Space; and
 - (c) as a proxy for some other measurement basis.
- 38 The depiction of an investee's ability to pay dividends to the investor is dependent upon the legal framework governing distributions. Although the equity method is superior to cost in showing changes in the net assets of the investee, this is not necessarily linked to an ability to pay dividends. This is particularly the case where the initial investment was made at a price other than the investee's book value (including where the investment was made by purchase of shares from a third party).
- 39 For countries with a specified capital maintenance approach to distributions, the ability to pay dividends may be constrained by other factors that would not be depicted by the equity method, such as non-distributable reserves. For countries with a solvency approach to distributions, the ability to pay dividends would only be depicted if the carrying value of the investment was exactly equal to the investor's share of the investee's net assets: causing problems as noted above and in paragraph 85 of the DP.
- 40 If the equity method is used to depict the special relationship between an investor and an investee in the Problem Space, then we believe that this implies common accounting policies and eliminations (either Alternative 1 or Alternative 2). Both of these are needed to show the process of value creation as discussed in paragraphs 31 to 33 above. Depicting the special relationship without either of these would not be appropriate.
- 41 To the extent that the equity method could be used as a proxy for fair value, it is unlikely that its usefulness would be restricted to associates.

Chapter 4

Question

4.1 This paper includes the practical issues which are not defined or unclearly stated in IAS 28 (2011). Do you agree that the issues should be defined or more clearly stated in IAS 28 (2011)? If not, please explain.

4.2 Are there additional accounting treatments that IAS 28 needs to consider but are not addressed in this paper? If so, which additional issue needs to be addressed?

4.3 K-GAAP regulates different equity methods for associates and subsidiaries on stand-alone financial statements. Does your jurisdiction have the same experience as Korea?

4.4 Do you agree with distinguishing the equity method for subsidiaries from that for associates? Please explain.

EFRAG staff response

The EFRAG staff agrees that there are practical issues that are not defined or are unclearly stated in IAS 28 (2011). It would be helpful if these issues were addressed or more clearly stated, but this must come from clarity on the underlying principle of the equity method rather than

Practical issues which are not defined or unclearly stated in IAS 28 (2011)

- 42 We agree that there are a number of issues not defined or unclearly stated in IAS 28 (2011) and have discussed them further in the EFRAG Short Discussion Series Paper. These and other issues we are aware of are generally the same as those identified in paragraphs 199-226 of the DP.
- 43 Responses from constituents to the EFRAG Short Discussion Series Paper also identified the following issues:
- (a) contingent consideration arrangements;
 - (b) impairment testing;
 - (c) acquisitions carried out in stages;
 - (d) deferred taxes; and
 - (e) the challenge in obtaining sufficient information necessary to apply the equity method of accounting.
- 44 We agree that these practical issues should be defined or more clearly stated in accounting requirements for associates, with a clear underlying principle based on scope of economic activities. Addressing these issues without clarity on the underlying principle risks introducing rules-based requirements into IFRS. Continual ad-hoc amendments also risk introducing conflicts with existing literature and other IFRSs, as was seen with the IASB ED/2012/3 *Equity Method: Share of Other Net Asset Changes*

KASB Discussion Paper: The Equity Method
EFRAG Staff response

Different equity methods for associates and subsidiaries on stand-alone financial statements

- 45 We do not have information (or sufficient information) on cross-country application of the equity method within Europe and therefore are not able to respond to this question.
- 46 EFRAG staff acknowledges that separate financial statements have a different role in financial reporting than consolidated financial statements. The boundaries of the reporting entity are set on a legal, rather than economic, basis. The EFRAG/ICAC/OIC/RJ Discussion Paper *Separate Financial Statements* (available on the EFRAG website with a comment period ending on 31 December 2014) discusses this different role.
- 47 In separate financial statements, investments in subsidiaries and associates are both recognised as investments. Accordingly, we believe the accounting requirements should be similar.
- 48 If the equity method is used to measure the investor's interest in subsidiaries and associates in separate financial statements, we believe that the same approach should be used. We understand that there are attractions in having the investment in a subsidiary in separate financial statements measured equally to the net assets attributable to the investor in consolidated financial statements. However, we believe that there are other reasons, beyond the mechanics of the equity method, that mean that this would not necessarily be the case. Reasons that were identified by respondents to the IASB Exposure Draft ED/2014/10 *Equity Method in Separate Financial Statements* and noted in agenda paper 15A of the April 2014 IASB meeting include:
- (a) differences in the unit of account for impairment testing;
 - (b) if a subsidiary has net liabilities;
 - (c) reverse acquisitions;
 - (d) acquisition-related costs; and
 - (e) capitalisation of borrowing costs on assets of the subsidiary.
- 49 Although some of these (e.g. impairment testing) would be resolved through application of Alternative 1 to investments in subsidiaries, others would not. Differences between the measurement of the subsidiary in separate financial statements and the net assets attributable to the investor in the consolidated financial statements could therefore still remain.
- 50 We also believe that having more than one method of accounting called the equity method would be confusing in practice and we would therefore not support distinguishing the equity method for subsidiaries from that for associates.

Comments on Discussion Paper – 18 “The Equity Method”

1. We agree that IAS-28 does not clarify whether the equity method is a consolidation technique or a measurement basis for the investment.
2. IAS-28 does not allow the investor to recognize losses in excess to the carrying value of their investments, and further not cancelling out the inter-company receivables and payables, exhibit the characteristic resonating with measurement aspect. On the other hand, it provides a one-line consolidation without taking into account the share of loss of the investee in excess of amount of investment and requirement to eliminate the unrealized gain or losses on inter-company transactions.
3. The dual characteristic of the equity method requires the concept to be explicitly defined to remove any controversies resulting in dissimilar practices.
4. We propose that the dual characteristic of the equity method should be defined in IAS-28 and classified into two separate basis:
 - a. Equity method measurement basis: to be used by preparers of single company financial statements.
 - b. Equity method consolidation basis: to be used for presenting information of a group accounting structure. This basis will mirror the one-line consolidation including taking into account investor's share of all losses of investee etc.
5. The nature of the two financial statements, single company structure and the group structure, are inherently different and require different characteristics to be presented. We expect that the measurement characteristic of equity method is better suited for reflecting investments in single company financial statements, whereas the consolidation characteristic is better suited to present investment in group financial statements.

Response to Specific Questions:

1.1 & 1.2: Due to non-availability of repository of data relating to ratios of subsidiary and associates, we can neither provide such data nor make any estimate.

3.1 Scope of Group, as a new dimension, would require significant judgment. Further, preparers would require a great deal of guidance on when a particular approach (alternative 1, 2 or 3) would be used. We believe that we have suggested a more simplified approach to address the issues raised in research paper.

4.1 We agree that this issue should be clarified in IAS-28.

4.2 We are not aware of any other treatment being viable in similar circumstances.

4.3 IAS-28 is adopted, and the practice in our jurisdiction is not different from what is required under the standard.

4.4 Our suggestion to take account of losses in Equity method consolidation basis will result in similar accounting for subsidiaries and associates.



September 5, 2014

Mr. Ji Hun Park
Korea Accounting Standards Board
KCCI Building 4th Floor
39, Sejongdaero, Jung-gu
Seoul 100-743, South Korea

Dear Mr. Park:

Consejo Mexicano de Normas de Información Financiera (CINIF), the accounting standard setting body in Mexico, welcomes the opportunity to submit its comments on the KASB Discussion Paper No. 18 on *The Equity Method* (the DP) issued in June 2014. Set forth below you will find our comments on the topics included in the DP.

Overall Comments

First of all, in our comment letter on Exposure Draft ED/2013/10 on *Equity Method in Separate Financial Statements* (the ED) issued in December 2013, we have already communicated to the IASB that in Mexico we are very pleased with the decision to restore the equity method as one of the alternatives available for the recognition of investments in subsidiaries, associates and joint ventures in an entity's separate financial statements. We believe that the resulting information presented is consistent with the approach for the consolidation of financial statements, which we believe is appropriate, especially in the case of subsidiaries.

Nevertheless, we believe it is not advisable that there be three alternatives for the valuation of the aforementioned investments. In principle, we believe that accounting for such investments under the equity method should be required, not just allowed. We also strongly believe that accounting for such investments at cost should not be allowed, since such method does not represent current values. Finally, we also believe that accounting for such investments at fair value pursuant to IFRS 9, *Financial Instruments*, should only be allowed to account for interests in investment entities, as established in IFRS 10, *Consolidated Financial Statements*.

It should also be noted that as opposed to the situation in Korea, the consolidated financial statements, not the separate financial statements, are considered to be the primary financial statements of listed companies in Mexico.

In **our** comment letter on the ED we also communicated to the IASB that we believe the net profit or loss and the equity in an entity's separate financial statements should not differ from the net profit or loss and the equity in the same entity's consolidated

financial statements. To ensure this is the case in the majority of situations, our local standards establish that the limitation on the recognition of the losses of associates and joint ventures contemplated in our equity-method standard does not apply to the application of the equity method to subsidiaries in separate financial statements.

We observe that the IASB carefully considered whether to require use of the same equity method for subsidiaries, associates and joint ventures. We note paragraph BC10G of revised IAS 27 states:

In general, the application of the equity method to investments in subsidiaries, joint ventures and associates in the separate financial statements of an entity is expected to result in the same net assets and profit or loss attributable to the owners as in the entity's consolidated financial statements. However, there could be situations in which applying the equity method in separate financial statements to investments in subsidiaries would give a different result compared to the consolidated financial statements. Some of those situations are:

- (a) impairment testing requirements in IAS 28. For an investment in a subsidiary accounted for in separate financial statements using the equity method, goodwill that forms part of the carrying amount of the investment in the subsidiary is not tested for impairment separately. Instead, the entire carrying amount of the investment in the subsidiary is tested for impairment in accordance with IAS 36 Impairment of Assets as a single asset. However, in the consolidated financial statements of the entity, because goodwill is recognised separately, it is tested for impairment by applying the requirements in IAS 36 for testing goodwill for impairment.*
- (b) subsidiary that has a net liability position. IAS 28 requires an investor to discontinue recognising its share of further losses when its cumulative share of losses of the investee equals or exceeds its interest in the investee, unless the investor has incurred legal or constructive obligations or made payments on behalf of the investee, in which case a liability is recognised, whereas there is no such requirement in relation to the consolidated financial statements.*
- (c) capitalisation of borrowing costs incurred by a parent in relation to the assets of a subsidiary. IAS 23 Borrowing Costs notes that, in some circumstances, it may be appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted average of the borrowing costs. When a parent borrows funds and its subsidiary uses them for the purpose of obtaining a qualifying asset, in the consolidated financial statements of the parent the borrowing costs incurred by the parent are considered to be directly attributable to the acquisition of the subsidiary's qualifying asset. However, this would not be appropriate in the separate financial statements of the parent if the parent's investment in the subsidiary is a financial asset, which is not a qualifying asset.*

Unfortunately, the IASB decided not to establish a modified equity method for subsidiaries in separate financial statements to ensure that the net profit or loss and the equity in an entity's separate financial statements does not differ from the net profit or loss and the equity in the same entity's consolidated financial statements.

Below we present our responses to the specific questions included in the DP:

Questions for constituents

Question 1.1 — Significance of equity method for associates
--

In Korea, associates take up a significant portion of financial statements. Please provide us with the following ratios of your jurisdiction:

- | |
|---|
| (a) The proportion of the carrying value of equity-accounted investments for associates, compared to total assets of consolidated financial statements; |
| (b) The proportion of the equity method net income from associates, compared to the total net income of consolidated financial statements; |
| (c) The proportion of the equity method net income from associates, compared to the total net income of separate financial statements |

Although we do not have reliable calculations of the proportions of the carrying values of associates accounted for under the equity method to total assets of consolidated financial statements, or the proportions of the net income from associates to total net income of consolidated or separate financial statements, we can tell you that typically the carrying values of equity-method investments, i.e. associates, to total assets and the proportion of the net income from such investments to total net income of both consolidated and separate financial statements is not significant in Mexico. Mexican entities generally seek to have control and not just significant influence over their investees.

Question 1.2 — Significance of equity method for subsidiaries
--

In Korea, the effect of the equity method net income from subsidiaries on the financial statements is more significant than that from associates. Please provide us with the following ratios of your jurisdiction:

- | |
|---|
| (a) The proportion of the carrying value of equity-accounted investments for subsidiaries, compared to total assets of consolidated financial statements; |
| (b) The proportion of the equity method net income from subsidiaries, compared to the consolidated total net income; |
| (c) The proportion of the equity method net income from subsidiaries, compared to the parent's net income in the separate financial statements |

We should mention that in Mexico subsidiaries are not accounted for under the equity method in consolidated financial statements as all subsidiaries must be consolidated.

On the other hand, although we do not have reliable calculations of the proportions of the carrying values of subsidiaries accounted for under the equity method in separate financial statements to total assets or the proportions of the net income from subsidiaries to total net income of separate financial statements, we can tell you that such amounts are frequently very significant.

Question 1.3 — Use of equity method in separate financial statements

Has your jurisdiction used the equity method on the stand-alone financial statements? If yes, please provide us with the year when you started using it and, if stopped, the year when you stopped using it.
--

In Mexico we have always used the equity method to account for associates, subsidiaries and joint ventures in separate financial statements. When the use of IFRS became mandatory for all listed companies, other than those in the financial service, insurance and bonding sectors, and separate financial statements are prepared for legal purposes, they are usually prepared under IFRS and IAS 27, generally reflecting investments in associates, subsidiaries and joint ventures at cost. Occasionally,

separate financial statements are prepared under Mexican Financial Reporting Standards (MFRS) pursuant to which the equity method is followed.

Question 3.1 — “Scope of group” concept
--

In the past, the concept of equity method contrasted between the concept of one-line consolidation and measurement basis. This report suggests three alternative concepts of equity method based on a new dimension, the scope of group. Do you think a scope of group is an appropriate dimension? Do you agree with this concept? If not, please explain.

We have no problems with your “scope of group” concept. Further, most of our constituents believe that your Alternative 2, whereby only the investor’s share of associates is included in the group and transactions with associates are eliminated only to the extent of the investor’s share of the associates, is the most appropriate approach to be used.

Question 3.2 — Other comments

Do you think that there are other dimensions to establish the concept of the equity method?

We have not discovered any other dimensions to establish the concept of the equity method.

Question 4.1 — Practical issues
--

This paper includes the practical issues which are not defined or unclearly stated in IAS 28 (2011). Do you agree that the issues should be defined or more clearly stated in IAS 28 (2011)? If not, please explain.
--

In Mexico we believe that the concept of “significant influence” is adequately defined.

Question 4.2 — Additional issues to be addressed

Are there additional accounting treatments that IAS 28 needs to consider but are not addressed in this paper? If so, which additional issue needs to be addressed?
--

In Mexico we have not identified any additional issues that need to be addressed.

Question 4.3 — Different equity methods
--

K-GAAP regulates different equity methods for associates and subsidiaries on stand-alone financial statements. Does your jurisdiction have the same experience as Korea?
--

Yes. In Mexico, as under K-GAAP, MFRS require different equity methods for associates and subsidiaries in separate financial statements. Specifically, our standard for consolidated financial statements also addresses separate financial statements. Our standard on separate financial statements states the following:

In separate financial statements, interests in subsidiaries should be presented as permanent investments measured using the equity method, for which the guidance in NIF C-7 (our equity method standard) should be followed. When applying NIF C-7, with respect to the recognition of losses in the application of the equity method, the losses referred to in item d) of paragraph 41.2.3.9 of NIF C-7 should be recognized in their entirety by the holding company as a liability with the corresponding charge to the results of the period.

Paragraph 41.2.3.9 of our NIF C-7 states the following:

Losses of the associate or joint venture should be recognized by the holding company in the corresponding proportion as follows:

- a) *in the permanent investment, including goodwill, only until the investment is zero;*
- b) *if there is any excess after applying a) above, this should be applied, up to reducing them to zero, to any long-term accounts receivable that the holding company considers uncollectible and in essence are considered by the holding company to be part of its investment in the associate or joint venture (quasi investment);*
- c) *if any excess still remains after applying b) above, this should be recognized as a liability to the extent that the holding company has incurred legal or assumed obligations in the name of the associate or joint venture;*
- d) *any excess losses derived from c) above should not be recognized by the holding company.*

Question 4.4 — Distinguishing equity methods

Do you agree with distinguishing the equity method for subsidiaries from that for associates? Please explain.

Yes, we agree, as evidenced by our local standard cited in our response to Question 4.3.

Should you require additional information on our comments listed above, please contact William A. Biese at (52) 55 5596 5633 ext. 106 or me at (52) 55 5596 5633 ext. 103 or by e-mail at wbiese@cinif.org.mx or fperezcervantes@cinif.org.mx, respectively.

Kind regards,

C.P.C. Felipe Perez Cervantes
President of the Mexican Financial Reporting Standards Board
Consejo Mexicano de Normas de Información Financiera (CINIF)

cc: Amaro Gomes

29 August 2014

Mr Ji Hun Park
Assistant Technical Manager
Korea Accounting Standards Board
Korea Chamber of Commerce and Industry Building
4th Floor 39 Sejong-daero
Jung-gu
Seoul 100-743
South Korea

By email: jhpark@kasb.or.kr and cc: hdchoi@kasb.or.kr

Dear Mr Park

Discussion Paper No. 18 The Equity Method

Thank you for the opportunity to comment on Discussion Paper No. 18 the Equity Method (the DP).

General comments

The New Zealand Accounting Standards Board (NZASB) is pleased the Korea Accounting Standards Board (KASB) has developed the DP to provide input into the IASB's research project on the equity method of accounting. In our view, reconsidering the use of the equity method of accounting is a significant matter and we hope that other AOSSG members will also provide input or otherwise support the KASB project. We also note that the equity method is a topical issue within the wider international accounting standard setting community and that the European Financial Reporting Advisory Group has also prepared a short discussion paper earlier this year.

The equity method originated a long time ago in response to the needs of the time and we believe that its continued application, including its usefulness to users and the complexities it presents to preparers, should be reviewed.

We note that the purpose of the DP is to provide a starting point for discussions on developing a better financial reporting standard on equity accounting. However, in our view, as noted in the conclusion to the DP, the starting point should be an exploration of whether the equity method should be retained at all.

Please note we have not responded to all the questions raised in the DP. However, we have provided comments that we believe are important for the IASB to consider in their research project.

Equity accounting in New Zealand

We reviewed the latest audited financial statements of the 50 largest and most liquid companies listed on the New Zealand Stock Exchange. We found that 28% of these entities had associates that were accounted for using the equity method. On average, the carrying value of investments in associates made up 2.35% of the total consolidated assets and the share of associates' profit made up 6.05% of the consolidated net profit after tax excluding other comprehensive income.

In New Zealand, entities acquiring more than 20% in a New Zealand registered company are subject to the Takeovers Code (the Code). The Code is a regulation that prohibits an increase in an investor's shareholding above 20% unless specific procedures are followed, as set out in the Takeovers Code. This may cause entities to avoid increasing their shareholding above 20% and hence the Code may be a barrier for entities to achieve the level of influence required to apply the equity method for their investments.

Based on our analysis of the above 50 companies and other anecdotal evidence, it seems clear that the extent of equity-accounted investments in New Zealand is significantly less than in South Korea. Nevertheless, for entities with equity-accounted investments, difficulties arise in practice when accounting for such investments.

Based on our own understanding and some limited outreach, including discussion with a number of accounting firms, we agree with the KASB that the conceptual basis for the equity method is unclear, which creates difficulty in practice. In addition, we are aware that the following practical difficulties are encountered when applying the equity method:

- (a) The information necessary to apply the equity method often is not available and the investor does not have the power to require the associate to provide this information.
- (b) Application of the equity method requires an investor to determine any fair value adjustments and goodwill arising from the acquisition of the investment in the associate. These fair value adjustments are unlikely to be recognised in the associate's financial statements, giving rise to the need for adjustments in determining the equity accounted results going forward.
- (c) Often the balance date and accounting policies of the investor and associate are not aligned giving rise to a number of adjustments in applying the equity method.
- (d) It can be difficult to determine the upstream and downstream transactions between the investor and associate and to eliminate gains/losses on these transactions appropriately.
- (e) Accounting for changes in ownership of an associate whilst retaining significant influence can also be complex.

The concept of the equity method

We agree with the KASB that the concept underlying the equity method is unclear. The equity method is sometimes viewed as a measurement basis and at other times is viewed as a one-line consolidation. The concept is particularly unclear in cases where investors hold large percentage interests in investees but do not control the investees.

We agree that it is appropriate to consolidate controlled entities and it generally makes sense for investments in non-controlled entities to be accounted for at fair value. However, it is unclear whether a different method of accounting is appropriate for some interests in non-controlled entities and, if so, in what circumstances.

In considering this matter conceptually, we support the KASB's approach of considering the scope of the group. We believe that the scope of the group is the key for determining whether there is a conceptual basis for the equity method and, if so, what that conceptual basis might be.

We also believe that when considering the scope of the group, this issue needs to be considered in the context of the IASB's Conceptual Framework project, in particular, the reporting entity concept and its relationship with the definition of an asset.

IASB's research project

We consider that the IASB's research project should take a principled-approach to reviewing the use of the equity method. As noted above, we support the KASB's approach of considering the scope of the group, in conjunction with the IASB's Conceptual Framework project, in order to establish whether the equity method has a conceptual foundation and, if so, what that conceptual foundation might be. Once that has been determined, other issues should be considered in the context of that underlying concept. These issues include the following:

- (a) The IASB should consider what the asset is that is intended to be represented (i.e. the unit of account). Some aspects of equity accounting, as it exists today in IAS 28 *Investments in Associates and Joint Ventures*, implies that the investor's asset is a share in the underlying assets of the investee; not the investment in the investee itself.
- (b) The IASB should focus on user needs; that is, the IASB should determine whether there are characteristics of certain non-controlled entities that distinguish them from others and give rise to different user information needs that require or permit a measurement basis other than fair value. For example, the equity method may be appropriate when entities have joint control of an investment.
- (c) The IASB should consider alternatives to equity accounting. If these alternative accounting treatments result in the loss of some information that users require, the IASB could consider supplementing this with disclosures that provide information that users need.

If you have any queries or require clarification of any matters in this letter, please contact Aimy Luu Huynh (aimy.luuhuynh@xrb.govt.nz) or me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Kimberley Crook', written in a cursive style.

Kimberley Crook
Chair – New Zealand Accounting Standards Board

31 August 2014

Korea Accounting Standards Board
KCCI Building, 4th Flr.
39, Sejongdaero, Jung-gu
Seoul 100-743, South Korea

Email: jhpark@kasb.or.kr/hdchoi@kasb.or.kr

Dear Sir/Madam

THE SOUTH AFRICAN FINANCIAL REPORTING STANDARDS COUNCIL (FRSC) AND THE SAICA ACCOUNTING PRACTICES COMMITTEE (APC) SUBMISSION ON THE KOREA ACCOUNTING STANDARDS BOARD'S DISCUSSION PAPER NO 18: *THE EQUITY METHOD*

In response to your request for comments on the Discussion Paper No 18: *The Equity Method*, attached is the comment letter prepared by the FRSC and the APC. The FRSC is the legally constituted financial reporting standard-setter in South Africa formed in October 2011. The APC is the technical accounting committee of SAICA that comprises members from reporting organisations, regulators, auditors, IFRS specialists and academics.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours faithfully,

Mr Jeff van Rooyen
Chairman of the FRSC

Prof Danie Coetsee
Chairman of the APC

cc: Diederik Esterhuizen – Director - FRSC
Sue Ludolph – SAICA Project Director: Financial Reporting
Bongeka Nodada – SAICA Project Director: Financial Reporting Standards

THE FRSC AND THE SAICA APC SUBMISSION ON THE KOREA ACCOUNTING STANDARDS BOARD'S DISCUSSION PAPER NO 18: *THE EQUITY METHOD*

GENERAL COMMENTS

Underlying concept of the Equity Method: (Measurement or Consolidation basis)

The Discussion Paper highlights the two viewpoints regarding the concept of the equity method. One view is that the equity method is a consolidation basis (one-line consolidation) and the other is a measurement basis for the investment. However, IAS 28 – *Investments in Associates and Joint Ventures*, does not clarify which of these two viewpoints is the underlying concept of the equity method. This is a fundamental issue as it directly affects the inconsistencies and complexities of the equity method.

The FRSC and the APC believe that the underlying concept of the equity method is a measurement basis and not a consolidation basis, due to the principles that are contained in the equity method.

In line with IFRS 10¹ – *Consolidated Financial Statements*, definition of the group 'Parent and its subsidiaries' the FRSC and the APC are of the view that associates do not form part of the group and thus there is no requirement for consolidation. Control is the main factor in the definition of the group. Definition of joint control in IFRS 11² – *Joint Arrangements*, is also based on the contractually agreed sharing of control. The entities that are not under control, do not form part of the group thus, there is no requirement for consolidation.

Two issues that the FRSC and the APC considered regarding the underlying concept of the equity method are:

- i) Does the equity method provide for measurement?
- ii) Is an investment in an associate an IFRS 9 – *Financial Instruments*, financial instrument?

(i) *Does IAS 28 provide for measurement?*

The current equity method contains intercompany eliminations, as it is currently not a measurement standard. However, it comprises elements of both measurement and consolidation. Increasing or decreasing the investment in an associate with the investor's share of profits or losses of the investee after the acquisition date is a form of measurement or valuation of the investment. The equity method thus, provides for measurement of the investment. However, it also contains consolidation principles.

(ii) *Is an investment in an associate an IFRS 9 – Financial Instrument?*

The scope of IFRS 9, excludes interests in associates, IAS 28³ – *Investments in Associates and Joint Ventures*. Therefore, the interest in associates and joint ventures measurement principles are contained in IAS 28 and not in IFRS 9.

¹ IFRS 10 Consolidated Financial Statements Appendix A defined terms

² IFRS 11 Joint Arrangements, paragraph 7

³ IAS 28 Investments in associates or Joint Ventures, paragraph 14

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Using fair value may be difficult due to the nature of the investments i.e. normally not publicly traded. The FRSC and the APC thus, discussed net asset value as a possible option for valuation of investments in associates, with additional disclosures in IFRS 12 – *Disclosure of Interests in Other Entities* and IFRS 13 – *Fair Value Measurement*.

The FRSC and the APC notes that, if the equity method is a measurement basis then there might be a reduction in the complexities and inconsistencies, which the equity method presents when it interacts with other standards. However, if the equity method is a consolidation method then we agree that the complexities and inconsistencies highlighted in the discussion paper require attention.

Using the equity method as a measurement/valuation basis will not result in eliminating intercompany transactions, thus it will be possible to have a gain/loss from changes in indirect treasury shares (which are shares held by the associate in the company applying the equity accounting). This complication will result from applying the current equity method as valuation technique.

If the equity method is considered to be a measurement basis, the question is whether the current measurement options included in IFRS 9 are sufficient or whether an alternative measurement basis should be developed in IFRS 9. If an alternative measurement basis is not required, then IAS 28 is not relevant. If there is a need for the equity valuation method then the question is whether the equity method should be included in IFRS 9 or IAS 28. If in IFRS 9, the equity method or the new valuation basis will have to address the recognition of the financial instrument value adjustment changes i.e. profit or loss or other comprehensive income movements. Disclosures of interest in other entities in accordance with IFRS 12, will address the disclosure of information of associates and joint ventures, and disclosures similar to those in IFRS 13 – *Fair Value Measurement*, may be relevant.

The responses to the questions in the Discussion Paper are drafted with a view that the equity method should be a measurement or valuation basis.

SPECIFIC COMMENTS

Question 1.1

In Korea, associates take up a significant portion of the financial statements. Please provide us with the following ratios in your jurisdiction.

- a) The proportion of the carrying value of equity-accounted investments for associates, comparing to total assets of consolidated financial statements*
- b) The proportion of the equity method net income from associates, comparing to the total net income of consolidated financial statements*
- c) The proportion of the equity method net income from associates, comparing to the total net income of separate financial statements*

For the calculation of the proportions, please use absolute values. If you do not have reliable data for the calculation, please provide us with your best estimation.

We currently do not have the statistical information of the associates in South Africa. However, we believe that associates make up a significant portion of financial statements in South Africa.

Question 1.2

In Korea, the effect of the equity method net income from subsidiaries on the financial statements is more significant than that from associates. Please provide us with the following ratios of your jurisdiction.

- (a) The proportion of the carrying value of equity-accounted investments for subsidiaries, compared to total assets of consolidated financial statements*
 - (b) The proportion of the equity method net income from subsidiaries, compared to the consolidated total net income*
 - (c) The proportion of the equity method net income from subsidiaries, compared to the parent's net income in the separate financial statements.*
- a)*

For the calculation of the proportions, please use absolute values. If you do not have reliable data for the calculation, please provide us with your best estimation.

Entities in South Africa currently do not apply the equity method for investment in subsidiaries in the separate financial statements.

Question 1.3

Has your jurisdiction used the equity method on the stand-alone financial statements? If yes, please provide us with the year when you started using it and, if stopped, the year when you stopped using it.

The equity method has not been used in the stand-alone financial statements until the recent amendment to IAS 27 allowing this application.

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Question 3.1

In the past, the concept of equity method contrasted between the concept of one-line consolidation and measurement basis. This report suggests three alternative concepts of equity method based on a new dimension, the scope of group. Do you think a scope of group is an appropriate dimension? Do you agree with this concept? If not, please explain.

We do not agree that the scope of a group is an appropriate dimension. We see the equity method as a measurement or valuation basis that could be used also in the stand-alone financial statements. Please refer to comments above on the 'Underlying concept of the equity method: measurement or consolidation method' under the General Comments section.

Question 3.2

Do you think that there are other dimensions to establish the concept of the equity method?

No, we see the equity method as a measurement or valuation basis. Please refer to comments above on the 'Underlying concept of the equity method: measurement or consolidation method' under the General Comments section.

Question 4.1

This paper includes the practical issues which are not defined or unclearly stated in IAS 28(2011). Do you agree that the issues should be defined or more clearly stated in IAS 28(2011)? If not, please explain.

We have noted that, applying the equity method as a measurement basis addresses most of the complexities and inconsistencies that are contained in IAS 28, as most of the issues relate to consolidation. However, as noted under the General Comments section, using the equity method as a measurement/valuation basis will not result in eliminating intercompany transactions, thus it will be possible to have a gain/loss from changes in indirect treasury shares.

Question 4.2

Are there additional accounting treatments that IAS 28 needs to consider but are not addressed in this paper? If so, which additional issue needs to be addressed?

The discussion paper covers the practical issues of the equity method for consolidation extensively and we agree with those issues.

Question 4.3

K-GAAP regulates different equity methods for associates and subsidiaries on the stand-alone financial statements. Does your jurisdiction have the same experience as Korea?

No. The South African jurisdiction applies IAS 28 as a consolidation basis and there are no other additional regulations on the application of the equity method.

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Question 4.4

Do you agree with distinguishing the equity method for subsidiaries from that for associates? Please explain.

We are of the view that the equity method is a valuation basis, thus do not agree with the method used as a consolidation basis. However, if the equity method is a valuation basis, this option should be available to stand-alone financial statements for valuation of the investments in subsidiaries.

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