IASB EMERGING ECONOMIES GROUP 7th MEETING

ISSUES FOR DISCUSSON:

The Equity Method

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Korea Accounting Standards Board

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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 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 group" and presents three alternative concepts of the equity method, as well as explains how the equity method accounting standard can vary under each of the three alternative concepts. Secondly, based on our experiences of practice 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, when IFRS was adopted, Korean GAAP requires the application of equity method in the stand-alone financial statements. Therefore, Korea has accumulated extensive experience on resolving equity method-related issues, which could provide valuable insights to the IASB in amending IAS 28. Lastly, this paper reports the results of 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 a consistent application of the equity method.

4. 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. 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

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 method[1.] 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 the equity method accounting should be. Specifically;

7. First, the equity method accounting standard can 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 exists 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 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 equity method is one-line consolidation, then in any circumstances, the losses of equity-accounted investees need to be recognized by the investor. The accounting standard in which the losses of equity-accounted investees are not recognized under certain circumstances as in the current IAS 28 concords 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.

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

8.1. When a specific accounting guidance is not provided, financial statements preparers and accounting firms would create a new one 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 end up developing 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 upon concept of the equity method.

8.2. When the IASB adds a 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 a guidance or interpretation consistent with the current IAS 28. One example is the ED published on 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 due to lack of a clear concept, the IASB included the equity method in its research project agenda. However, the IASB has not taken any actions to conduct further research on the equity method. It appears that the IASB does not fully recognize the importance of the equity method accounting.

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

11. One of the reasons why the IASB does not recognize the importance of the equity method seems to be that, under IFRS where the consolidated financial statements are the main financial statements, the equity method that is applied only to associates[2] might be viewed as relatively less important. However, the impact of the equity method is significant.

11.1. First, associates do not take an insignificant 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

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

consolidated financial statements. The equity method net income accounts for 72. 85% of the total net income of consolidated financial statements. As shown, the equity method makes a significant impact on the consolidated financial statements.[3]

11.2. Secondly, the proportion of equity method net income from associates to separate financial statements' net income is 59. 26%, which again has a significant impact on the separate financial statements.

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 for their decision making.

Table 1-1. The Impact of the Equity Method on Financial Statements in Korea [4]

	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%[6]	77. 36%[56]
Equity method net income on parent company's net income in separate financial statements*	59. 26%[6]	113. 42%[6]

* Computed by using absolute values

Question to constituents

1. 1 In Korea, associates take up a significant portion of financial statements. Please provide us with

3 The data was hand-collected from the notes of audit report.

4 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 asset was less than 0, and those whose fiscal year-end was not December. The result is 746 firms.

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)

the following ratios of 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.

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

12. In addition, in December 2013, the IASB published the ED, allowing the usage of the equity method in the separate financial statements. This new proposal implies the extended usage of the equity method accounting. In the past, the usage of the equity method was limited only for associates in consolidated financial statements, but once the ED gets approved, it will be extended not only to associates but also to subsidiaries.

13. If application of the equity method is allowed to the separate financial statements and thus if the equity method is applied to associates and subsidiaries as well, then its impact on the financial statements will be material.

    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.

Question to constituents

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 following ratios of your jurisdiction.

(a) The proportion of the equity method net income from subsidiaries, comparing to the consolidated total net income

(b) The proportion of the equity method net income from subsidiaries, comparing 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.

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 redundancy (for example, the net income reported in the separate financial statements must be the same as the net income that belongs to 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 separate financial statements that uses 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.

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 can 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 on 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.

Question to constituents

1. 3 Have 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.

15. In summary, the effect of the equity method on financial statements is not ignorable. Actually it is significant. If the equity method is allowed in the separate financial statements, the importance of the equity method will grow even to a 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. Before using the equity method in the separate financial statements, the IASB should take careful considerations for numerous unexpected issues.

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 on the current IAS 28 and suggesting interim alternatives. More specifically,

    16.1. Firstly, the history of the equity method has been reviewed. In addition, we have compared the GAAPs among Germany, 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 group,' we have introduced 3 alternative concepts of the equity method. 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, we presented additional issues that the IASB should consider when carrying out the equity method research project, including the expected issues when the equity method is allowed 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, we have tested whether the equity method-applied separate financial statements can provide more valuable information comparing 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. Up to this point, this paper has examined the equity method that has been developed on through history based on two different concepts – consolidation and measurement. Hereafter, we would like to take a look at the Germany, United States and Korea through history based on two different concepts – consolidation and measurement in each respective jurisdiction.

Equity method in German GAAP[7]

19. German GAAP is defined by German commercial law (Handelsgesetzbuch, hereafter "HGB").

20. 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.

21. German GAAP accounts for the associates using the equity method in the consolidated financial statements only.

22. German GAAP allows two variations of the equity method. In other words, entities can 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.

23. *Book value method*[8] recognizes the associate at acquisition cost including goodwill. *Book value*

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[7] 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 overlook the equity method accounting of local GAAP (especially, Germany and Korea) before the application of IFRS.

[8] 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

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.

24. 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 investor's share is considered in the equity method.

25. 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 consolidation[9].

26. Under German GAAP, the viewpoints regarding the equity method are analyzed as follows:

27. 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.

28. Second, under German GAAP, the transactions between the investor and the associates can be proportionately or fully eliminated. Since HGB allows full elimination, it seems that the HGB

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share of the differences, and the cost of the shares attributable to non-controlling interest are ignored.

[9] 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 assets at acquisition date	CU 4,000 (1,200 for 30% interest)
The fair value of the associate's net assets 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

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.

29. 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

30. To summarize, under German GAAP, the equity method for the associates is applied only in the consolidated financial statements. The purpose of this is by presenting profit and loss of associates on which the investor has a lower level of influence than on the subsidiaries, to show the effect of consolidating associates in the consolidated financial statements. 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 having a mixed viewpoint.

Equity method in US GAAP

31. 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.

32. First of all, under US GAAP, investment on 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.

33. 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 associate are accepted without any adjustment of the effects of significant events or transactions that occur 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 can 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 asset in nature.

34. 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 and etc. However under US GAAP, the Investor recognizes the impairment loss only when the associate's stock price has fallen other-than-temporary. Additionally, the investor does not perform impairment test separately for goodwill or the associate's assets.

35. Lastly, in the case when the investor loses significant influence on 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 remaining investment. The reason is that 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 measure at fair value.

36. As we have observed above, US GAAP's equity method has many characteristics of measurement approach. However, the consolidation viewpoint is not completely precluded.

37. First, according to US GAAP, when an investor initially acquires the equity method financial instrument, directly attributable transaction cost is recognized as the acquisition cost of 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 assets and the cost of acquisition is recognized as goodwill. This accounting treatment helps to stimulate the same effect as consolidation on investor's financial statement.

38. Second, unrealized profits or loss from transactions between the investor and the associates are eliminated.

39. 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 category in financial assets. However, we can see that the consolidation viewpoint is not completely precluded.

Equity method in Korean GAAP

40. The equity method of K-GAAP[10] discussed in this section is with regard to stand-alone financial

[10] 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 amendment of old K-GAAP to incorporate key concepts of IFRS while to simplifying the old K-GAAP so as to give less burden to unlisted companies. In this section of the report, we overlook the equity method of old K-GAAP that

statements (not the consolidated financial statements) which were viewed as primary financial statements before Korea adopted IFRS in 2011.

41. 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. As a result, K-GAAP's equity method could be considered as a substitute for consolidation, and various equity method related issues could be interpreted in the viewpoint of consolidation. The concept of the consolidation viewpoint in K-GAAP is summarized as follows:

42. 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 subsidiaries[11] 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.

43. 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 to be consistent with the result of consolidation.

44. 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 profit or loss from transactions with associates are eliminated only to the extent of the investor's ownership interest which produces the same effect as consolidation.

45. Third, in recognizing the impairment loss for associates, if this 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 consisting of underlying assets of associate, fair value adjustment and goodwill.

46. Lastly, it is required that the uniform accounting treatment with the investor be applied for associates.

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has been used before the adoption of IFRS.

[11] 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 more in detail in Chapter 4.

47. 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.

48. 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 by 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 of a financial asset.

49. Second, the impairment indicator of the associates under K-GAAP refers to the impairment indicators of financial assets. In other words, an investor has a view that the nature of the associate is not a part of investee's business but a financial asset. It also represents the measurement viewpoint.

50. 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

51. As explained above, the equity method has developed very distinctly in Germany, 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.

52. Consequently, 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 GROUP

53. 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 concepts of the equity method are mixed in the standards for the equity method, in fact these are seemingly unrelated concepts. We believe that the lack of dimension differentiating the different concepts of the equity method has created the mixtures of the concepts giving rise to internally inconsistent standards for the equity method.

54. 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 in creating alternative equity method accountings that are more internally consistent. For this purpose, we propose the new dimension, "*scope of group,*" to define the underlying concepts of the equity method.

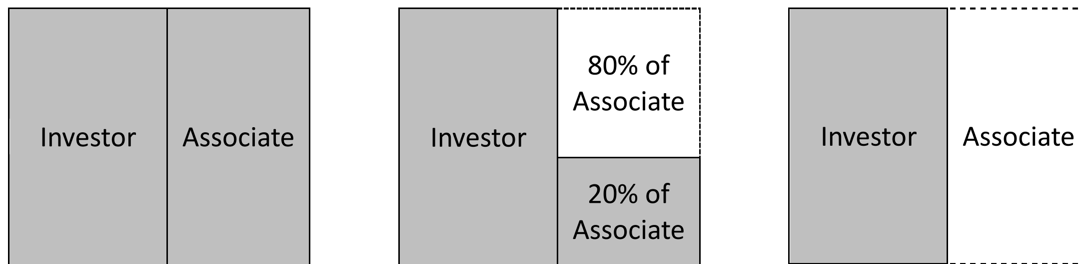
55. Group is '*a single economic entity'* consisting of an investor and its associate. Group may include the associate as a whole, a part of the associate, or none of the associate, depending on the extent of inclusion of the associate in the investor's group. Scope of group can be seen as one of the 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 group. With this new dimension, we could bring the old concepts of the equity method – one-line consolidation and measurement basis – on one continuum. 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

56. This report shows that depending on how to define the scope of group, the concept of equity method and the resulting accounting treatment may vary. We created three alternatives depending on the extent of inclusion of investee in the investor's group. The schematic view of the associate's assets and liabilities that are included in the group (the shaded part of the diagram) under the three alternatives are presented in the table below. It is assumed that investor's share is 20%.

Table 3-1. The Schematic View of Three Alternatives

Alternative 1	Alternative 2	Alternative 3



57. 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 group, the accounting treatments and the results may differ.

58. Alternative 1 is a concept that considers the associates as a part of a 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 share of associates as a part of a 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 a part of a group, so the investor does not recognize the assets and liabilities of the associates as his/her own.

59. 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 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 group' creates Alternative 2 that is an entirely different concept from the other two alternatives. This alternative is somewhat similar to the current IAS 28 and however, this is an internally consistent concept unlikely the current accounting standards for the equity method. In this chapter, we will analyze how to apply the alternatives of the equity method to the transactions.

CONCEPTS OF THE EQUITY METHOD UNDER THE NEW DIMENSION

Alternative 1

60. Alternative 1 is a method where associates are accounted for by presuming that the associates are part of the group. Thus, it is a method where the concept of group is applied not only to subsidiaries, but also extended to associates. When consolidating the subsidiaries, the consolidated net income/net assets are added together by viewing the parent company and the subsidiaries as one group, and next, within the consolidated net income/net assets, the portion attributable to the owners of the parent company is distinguished from that attributable to the non-controlling interest- i.e., NCI. By using the same concept of consolidation, amounts of associate's net profit and net assets attributable to the investor are determined by applying the same logic. When the associate's

net assets change, the change could be attributable to the investor and other owners of the associate. The change of the investor's the equity-accounted investment would be that amount attributable to the investor.

61. 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

62. Alternative 2 is a method that narrows down the scope of group to the investor's share in the associates. In other words, associates are included in the scope of group, similar to Alternative 1. However, 100% of the associates are not included in the scope of 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 as consolidated. This alternative coincides with the concept indicated in Paragraph 11 of the current IAS 28 (2011). The second half of the 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.** '

63. 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

64. Alternative 3 confines the scope of group to an investor and its subsidiaries. Thus, it is a concept where associates are not seen as a part of a group.

65. 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 assets of the associates.

66. 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 a group."

67. 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, assuming an associate is part of a group.	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, assuming that only the investor's share of an associate is part of a group.	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 a group.
Scope of a 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

68. 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.

68.1. For Alternative 1, since the investor and the investee are considered as part of one 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. Above transaction is an internal transaction within a group, therefore, the transaction effect is eliminated in full. In other words, the profit of CU 100 from disposal should be eliminated completely.

68.2. For Alternative 2, when the transaction between associate and the investor occurs, 80% of the transaction is considered to be a transaction outside the group and the remaining 20% is considered to be a transaction within a group. Therefore, adjustments need to be made in the investor's financial statements to exclude the 20% of the transaction as this is considered as an internal transaction within a 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, therefore, only the profit

of CU 20 should be eliminated.

68.3. For alternative 3, since an associate is not considered as a part of a group, no adjustment regarding internal transactions is necessary.

Questions to constituents
3.1 In the past, the concept of equity method contrasted between the concept of one-line consolidation and measurement basis. This report suggests the concept of equity method based on the scope of a group. Do you think a scope of group is an appropriate dimension? Do you agree with this concept? If not, why?
3.2 Do you think that there are other dimensions to establish the concept of the equity method?

APPLICATION OF THE ALTERNATIVES

69. In the preceding paragraphs, we have defined 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. The table below 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 **not** apply- i.e., allocation is not required
Recognition of changes in net assets of the associate	Recognized consistently with the associate's accounting	Recognized consistently with the associate's accounting	Recognized **in profit or loss (or other comprehensive income)** depending on the type of financial instrument
Recognition of changes in other capital transactions of the associate	Recognized **in equity**	Recognized **in profit or loss**	Recognized **in profit or loss (or other comprehensive income)** depending on the type of financial instrument
Uniform accounting policies	Required	Required	**Not** required
Losses of equity-accounted investees in excess of their carrying value	Further loss recognition **not** ceased	Further loss recognition **not** ceased	Further loss recognition **ceased**
Transaction with	**Fully** eliminated	**Only investor's share**	**Not** eliminated

associates		is eliminated	
Impairment of the investment	Impairment at **associate's assets level**	Impairment at **associate's assets level**	Impairment at **the investment level**
Assets held by the associate	Treated as if held **by investor**	Treated as if held **by investor (to the extent of the investor's share)**	Treated as financial instruments outside the group
Additional acquisition without obtaining control	Equity transaction	Non-equity transaction (initial recognition)	Non-equity transaction (initial recognition)
Additional acquisition resulting in obtaining control over the associate	IFRS 3 does **not** 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

70. 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).

70.1. As IFRS 3 is applied, the transaction costs for acquiring the equity-accounted investment is 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.

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

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

Alternative 3

71. 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.

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

72.1. Fair Value

This is the same approach that the current IAS39 has adapted. 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.

72.2. Acquisition cost

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

72.3. The carrying value of net assets

As Alternative 3 measures the value of the investment based on the net asset of an associate, carrying value of net assets 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.

73. Acquisition cost may not be equal to fair value of the investment. For example, marketable equity instruments could be acquired outside the market not at a consideration equal to market value or free of charge. Also, the carrying value of net assets 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 fair value.

74. Since the purposes of holding the equity accounted investment to which IFRS 9/IAS 39 is applied are different, 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)

75. 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 three alternatives of the 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 allocated are consistent

with Alternative 1 and 2.

Questions to constituents
3. 2 In relation to the initial recognition of the investment, do you think that application of three alternatives is consistent with the definition of them? If not, how do you think that the each alternative should be applied in initial recognition of the investment?

3. 3 In relation to the initial recognition of the investment, what additional considerations must be taken into account?

Recognition of changes in net asset of the associate

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

Alternative 1

77. Alternative 1 is a method which considers associates as part of the group, therefore, changes in net asset of the associate is 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 accounting treatment of associate's underlying transactions, which is the cause for the change in associate's net asset.

Alternative 2

78. 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. The only difference from alternative 1-i.e., the fact that "only" the share of the associate forms the investor's group would not make any difference in this regard, because under the both alternatives associate's assets and liabilities are considered to be held directly by the investor although it is only portion of them under Alterative 2.

Alternative 3

79. Under Alternative 3, the equity method would measure the value of the investment based on the net assets of an associate. However, the associate does not form investor's 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 corresponding account should be determined following the associate's underlying transaction that triggers the changes in net assets of the associate.

80. 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 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 at fair value through profit or loss and available-for-sale financial assets are measured at fair value with changes included in profit or loss or, for available-for sale financial assets, in OCI;

81. We would not propose whether profit or OCI is more appropriate and 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
Investor holds a 20% share of an associate and the associate has made CU 1,000 profit in the current period and the net assets also have increased by the same amount.

82. Under Alternative 1, the increase in the associate's net asset of CU 1,000 is regarded as the net asset increase of group. However, in the hypothetical consolidated financial statements that include the associate, among the increase amount, CU 800 is attributable to non-controlling interests, and the remaining amount of CU 200 is considered to be attributable to the investor. Therefore, the balance of equity-accounted investments is increased by CU 200 and the same amount is recognized as profit.

83. Under Alternative 2, the investor regards its share of the associate's assets and liabilities as being included 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*20%). Applying the same logic, in the income statement, the amount attributable to investor (CU 200) is recognized as investor's profit. Thus, equity-accounted investment increases by CU 200 and the same amount is recognized as profit.

84. As shown in the above paragraphs, when it comes to recognition of increase in net asset of associates, there is no difference in the increase to the balance of the equity-accounted investment between Alternative 1 and Alternative 2. However, there is a difference in the calculation of amount attributable to investor, which illustrates the distinction of the concepts between the two alternatives.

- Under Alternative 1, group's net assets increase by CU 1,000 resulting in the investor's share of them by CU 200.

- Under Alternative 2, group's net assets increase by CU 200.

85. 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 assets. Therefore, among the increase of CU 1,000 in the associate's net asset, the investor's share amount of CU 200 (CU 1,000*20%) is reflected in measuring the investment.

86. 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 assets 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 accounting treatment for the underlying transaction of the associate.

Example 3.2

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

87. This example is a variation of example 3-1 and the net assets of the associate increase with the same amount recognized as OCI rather than profit.

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

89. Under Alternative 3, equity-accounted investment increases by CU 200 as well but again, 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)

90. Under IAS 28 (2011), when an associate's net assets increase, the equity-accounted investment is increased by the investor's share amount. 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 on the investor's OCI. Thus, Alternative 1 and 2 are consistent with IAS 28 (2011).

Questions to constituents
3. 4 Regarding the recognition of changes in net assets of the associate, do you think that application of three alternatives is consistent with the definition of them? If not, how do you think that the each

alternative should be applied?
3. 5 Regarding the recognition of changes in net assets of the associate, are there any additional details that need to be considered?

Recognition of changes in other capital transactions of the associate

91. Change in associate's net assets may occur as a result of the associate's capital transactions in addition to reporting profit/loss or increase/decrease in other comprehensive income.[12] When the net assets of the associate change due to the associate's capital transactions, different consideration is required as these transactions might be a transaction with an owner of the group depending on the scope of group defined in each alternative.

Example 3.3

Facts

Investor holds a 20% share of an associate and the associate gets non-reciprocal capital contribution of CU 1,000 from its shareholder X in the current period. The associate accounts for this transaction as capital transaction by increasing share capital by the same amount because it sees X acting in its capacity as a shareholder. It is assumed that the investor's share percentage after the capital contribution remain the same at 20%.

Alternative 1

92. Under Alternative 1, the associate and investor are considered to be one group, therefore entity X becomes an owner of the group so the transaction is a capital transaction with the owner of the group. As a result of the transaction, equity-accounted investment increases by CU 200 and equity increases by the same amount.

Alternative 2

93. Under Alternative 2, since only the investor's share of the associate is included in the scope of group, remaining 80 percent share of the associate is out of group and entity X, as one of shareholders who owns that 80 percent of shares is not an owner of the investor's group. Among the increase of CU 1,000 in the associate's net asset, the investor's share amount of CU 200 is assumed to be a contribution to the investor's group from X who is not an owner of the group. As a result, the group's net asset increased by CU 200 because entity X has contributed CU 200 of its own assets to the investor. Thus, unlike Alternative 1, this transaction is not viewed as a capital transaction for the investor's group and as a result, under this alternative, the increase of the equity-accounted investment of CU 200 is accounted for in profit rather than in equity.

12 These transactions are dealt with in *Exposure Draft ED/2012/3 Equity Method: Share of Other Net Asset Changes*.

Alternative 3

94. Under Alternative 3, the equity-accounted investment is measured based on the net asset of an associate. In applying Alternative 3 in Example 3.1 and Example 3.2, we concluded that the corresponding account should be determined based on the type of investment itself rather than the underlying transaction of an associate.

95. Similarly in Example 3.3, the investor does not necessarily follow the same accounting treatment as the associate's. 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 and 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'.

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

Example 3.4

Facts
The associate has issued additional 5% of shares to the 3rd party X for cash of CU 1,000. Associate's net asset amount before issuing the share is CU 10,000 and as a result of the transaction, net asset of the associate becomes CU 11,000 (CU10,000 plus CU 1,000). The investor's ownership interest has decreased from 25% to 20%. Before issuing the share, investor's share is CU 2,500 (CU 10,000*25%) and after issuing shares the amount becomes CU 2,200 (CU 11,000*20%).

97. This transaction can be seen as if the following barter transactions have happened, resulting in decrease of the investor's share of net assets 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 net asset from X (CU 200= CU 1,000×20%).

Alternative 1

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

Alternative 2

99. With the same logic explained when applying Alternative 2 in Example 3.3, Since only the investor's share of the associate is included in scope of group under Alternative 2, remaining 80 percent share of the associate is out of group and entity X, as one of shareholders who owns that 80 percent of shares is not an owner of the investor's group. Therefore, the transaction between the investor and X are interpreted as a transaction with a third party. The investor contributes CU 300 to X. Thus, unlike Alternative 1, this transaction is not viewed as a capital transaction for the investor's 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

100. Under Alternative 3, the equity-accounted investment is measured based on the net asset of an associate. As explained in preceding example, the investor does not need to consider whether the assets are gained from its shareholders or third parties. 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)

101. The IAS 28 (2011) does not provide clear guidance on how to handle these types 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.

102. However, accounting treatments of Alternative 2 or 3 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 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."[13]

Questions to constituents

13 IFRIC Update 2013. 7, with highlight added.

3. 6 Regarding the recognition of changes in other net assets of the associate, do you think that each alternative is appropriately applied? If not, how do you think each alternative should be applied?
3. 7 Regarding Recognition of changes in other net assets of the associate, is there any additional thoughts that need to be considered?

Uniform accounting policies

Alternative 1 & 2

*103.*Since Alternative 1 and 2 consider the associate as entirely or partially in the scope of group, uniform accounting policies for the investor and its associates are necessary.

Alternative 3

104.Since the associates are not in the scope of group under Alternative 3, the carrying value of net asset of the associate, which is measured using the associate's own accounting policies should not be adjusted.

Comparison to IAS 28 (2011)

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

Question to constituents

3. 8 Do you agree with the idea that Alternative 1 and 2 need to require uniform accounting policies while Alternative 3 doesn't? If not, what do you think?

Losses of equity-accounted investees in excess of their carrying value

Alternative 1 & 2

106.If an associate is considered to be a part of a 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.

107.However, since 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 from the Conceptual Framework.

Alternative 3

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

Comparison to IAS 28 (2011)

109. Under IAS 28 (2011), if the investor does not have the responsibility to recoup the losses, then the application of the equity method should be ceased, which is consistent with Alternative 3.

Question to constituents

3. 9 Do you agree with the idea that Alternative 1 and 2 need to require discontinuation of the equity method when losses of equity-accounted investees exceed their carrying value while Alternative 3 doesn't? If not, what do you think?

Transaction with the associate

Alternative 1

110. Under Alternative 1, since the investor and the investee are considered as part of one 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 the transaction is eliminated and the profit and loss that occurred to associate is also eliminated in calculating the investor's share of the profit of the associate.

Alternative 2

111. 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 a group. Therefore, adjustments need to be made in the investor's financial statements to exclude the investor's share of the transaction as this is considered as an internal transaction within a group. As a result, among the effects of transaction between the investor and the associate, the portion of an internal transaction within a group should be eliminated through the equity method

Alternative 3

112. Under Alternative 3, since an associate is not considered as part of a 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

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.

113.The inventory sale is accounted for in the investors 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		

114.Under Alternative 1, the effects of transaction between the investor and the associate have to be entirely eliminated by using the following entry. As a result, the investor does not recognize any profit or loss from the inventory sales transaction.

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

115.Under Alternative 2, since only 20% of the transaction is a transaction within a group, only 20% of effects from the transaction has to be eliminated by using the following entry. As a result, the investor recognizes only 80% of the profit and loss from the inventory sale transaction.

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

116.Under Alternative 3, since the effect of transaction is not eliminated, profit of CU 500 from the sales of inventory is recognized in the investor's financial statements.

Example 3.6

Facts
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.

117.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

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

DEBIT	**CREDIT**
Equity method net income 100	Inventories 100

119.Under Alternative 2, since only 20% of the transaction is a transaction within a group, transaction that needs to be eliminated is not the whole transaction but is limited to 20% of the total transaction. 20% of 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 inventory sales transaction, which is recognized by the associate. This is the same result as Alternative 1, because only 20% portion 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	Inventories 100

120. Since transaction effect is not eliminated under Alternative 3, the investor's share amount out of CU 500 in profits recognized by the associate regarding the upstream inventory sale is recognized in the investor's financial statements.

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

Comparison to IAS 28 (2011)

122. 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.

Questions to constituents

3. 10 Regarding the transaction with its associate, do you think each alternative is appropriately stated? If not, how do you think each alternative should be applied?

3. 11 Regarding transaction with its associate, do you have additional thoughts that need to be considered?

Impairment of the investment

Alternative 1

123. Under Alternative 1, since the associate is considered to be a part of a group, the investor will apply impairment accounting for associate's assets and liabilities in the same way for the investor's own assets and liabilities. Therefore, the impairment accounting will be applied as follows:

123.1. Indicators of the impairment should be those 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. Therefore, the impairment indicators for non-financial assets should be applied.

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

123.3. 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.

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

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

123.6. Reversal of impairment loss is required.

Alternative 2

124. Under Alternative 2, a portion of the associate is considered to be a part of a group. Therefore associate’s assets and liabilities are regarded as being directly held by the investor like Alternative 1. The only difference from Alternative 1 is 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, 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

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

125.1. 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 consistently with the requirement for other financial assets.

125.2. 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.

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

Comparison to IAS 28 (2011)

126. Under IAS 28 (2011), the need for impairment test is decided by applying indicators of the impairment from IAS 39. The IAS 28 (2011) BCZ45[14] prohibits allocating impairment loss to associate’s individual assets. This is consistent Alternative 3. However, in the case where an associate recognizes the impairment loss, paragraph 32 of IAS 28 (2011)[15] states that an investor’s

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14 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.

15 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

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.

Questions to constituents
3. 12 Regarding impairment, do you think each alternative is appropriately stated? If not, how do you think each alternative should be applied?
3. 13 Is there additional thoughts that need to be considered regarding impairment?

Considerations of assets held by the associate

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

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

Example 3.7

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

Alternative 1 & 2

129.Under Alternative 1 and 2, the associate or a portion of the associate is a part of a group and therefore, 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

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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' 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.

130. Under Alternative 3, the shares issued by the investor that the associate owns are not considered being held by the investor.

Example 3.8

Facts
Investor hold 20% of Investee A and 15% of Investee B. Investee A holds 10% of investee B.

Alternative 1

131. 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

132. 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

133. Under Alternative 3, Investee B's shares held by Investee A are not considered being held by the investor.

Comparison to IAS 28 (2011)

134. The requirement for not combining shares through associates is stated in paragraph 27 of IAS 28 (2011)[16]. 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 is consistent with Alternative 3.

Questions to constituents
3. 14 Regarding assets held by the investee, do you think each alternative is appropriately stated? If

16 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.

not, how do you think each alternative should be applied?
3. 15 Regarding assets held by the investee, are there additional thoughts that need to be considered?

Additional acquisition

135. When equity method is continuously applied after Acquisition of additional shares of an associate, the accounting treatment for the change in investor's share of net assets of the associate may vary depending on which alternative is applied.

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

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

Example 3.9

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

Alternative 1

137.Under Alternative 1, since the associate and the investor are considered to be one group, entity Y is an owner of the group so that the transaction is a capital transaction with the owner of the group.

138.As Y is considered as an owner of the group, this transaction should be accounted for in the same accounting treatment that are 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.

139.As the associate as a whole has been included within the scope of a group since the existing 20% of shares acquired in the past, the additionally acquired 10 % portion of the associate also has been included in the 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 purchased is initially measured at CU 500 (the carrying value of existing 20% share of CU 1,000 * 10%/20%).

140.The fact that the existing 20% shares 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% shares measured at any amount other than CU 500 implies that net assets of the associate is being re-measured.

141. This investor is considered to receive 10% share of CU 500 in exchange for cash CU 600 and the difference of CU 100 is recognized in equity as in the entry below.

DEBIT	CREDIT
Equity-accounted investment 500	Cash 600
Equity 100	

Alternative 2

142. Under Alternative 2, since only the investor's share of the associate is included in the scope of group, remaining 80 percent share of the associate is out of group and Y, as one of shareholders who owns that 80 percent of shares is not an owner of the investor's group. Therefore this is not a capital transaction.

143. The only the 20% of the associate has been included within the scope of a group and the additionally acquired 10 % of share of the associate has not been included in the group. Therefore, the additional acquisition should be accounted for as the same as the initial acquisition of investments in an associate. The transaction is accounted for as below.

DEBIT	CREDIT
Equity-accounted investment 600	Cash 600

144. However, additional considerations are needed concerning whether to view the unit of account separately as 20% of share and 10% of share, or view 30% of share as one unit of account.

145. For example, an investor who owned 20% of the share of associate who only possesses land additionally acquired 10% of the same investee's share. When the existing 20% of the share was acquired, fair value of the associate's land was CU 1,000 and then the existing 20% was measured as CU 200. Since the initial investment in the associate, value of the land has increased and at the time of additional acquisition of 10%, the fair value of the land is CU 2,000. If the existing share and additional share are managed under different unit of account, then the land value of 20% of share is CU 200, and 10% of the land value will be CU 200. However, if these shares are managed as one unit of account, then the land value of 30% of share will combine to be CU 400.

Alternative 3

*146.*Under Alternative 3, the additional investment is measured consistently with the initial recognition.

Comparison to IAS 28 (2011)

147.Under IAS 28 (2011), additional acquisitions are not viewed as capital transaction, and therefore IAS 28 (2011) is consistent with Alternative 2. However, it is not clearly stated if existing holdings and additional acquisition should be accounted for as a separate unit of account.

Questions to constituents
3. 16 Regarding additional acquisition of associate's share, do you think each alternative was appropriately stated? If not, how do you think each alternative should be applied?
3. 17 Regarding additional acquisition of associate's share, are there additional thoughts that need to be considered?

Status changes to a subsidiary

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

Alternative 1

149.Under Alternative 1, equity-accounted associate is already part of a group; therefore the transaction of 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 transaction that deals with acquiring control over entity as changes in the nature of the investment.

Alternative 2

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

151.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 and the 30% of the entity within a 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 a group, the investor is considered to control only 30% of the entire assets and liabilities of the investee.

*152.*Therefore, when an equity-accounted associate becomes one of the subsidiaries, it is not a simple change in the extent of ownership interest of the associate but rather a change in nature of the investment due to the change in scope of a group and should be accounted for according to IFRS 3.

Alternative 3

153.Under Alternative 3, because it is the transaction of a financial asset becoming part of a group, changes in nature of the investment have occurred and IFRS 3 will be applied.

Comparison to IAS 28 (2011)

154.Under IAS 28 (2011), similar to Alternative 2 or 3, transaction of 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.

Questions to constituents
3. 18 Regarding status changes to a subsidiary; do you think that each alternative has been appropriately described? If not, how do you think each alternative should be applied?
3. 19 Is there additional consideration that needs to be made regarding the status changes to a subsidiary?

IAS 28 AND THREE ALTERNATIVES

155.In this report, the concepts of the equity method is defined using the scope of the 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 results on all three alternatives and we have compared these results to the applied results of the current IAS 28 (2001).

156.Below table shows result of comparing the above alternatives and the current IAS 28 (2011). As shown on the below table, it is evident that the current IAS 28 (2011) contains all 3 alternative's concept mixed in with its current standards.[17]

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 assets of the associate	★	★	
Recognition of changes in other capital transactions of the associate	★		

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

Uniform accounting policies	★	★	
Losses of equity-accounted investees in excess of their carrying value			★
Transaction with its associate- to what extent gain/loss is eliminated		★	
Impairment of the investment	★	★	★
Assets held by the associate			★
Additional acquisition		★	★
Acquisition of control over the associate		★	★

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

- Consideration transferred -i.e., 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 of other net assets of the investment is recognized in equity.
- Uniform accounting policies are required.
- In eliminating effects of 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, investor's share of the associate's profit or loss after acquisition appropriately adjusted in order for impairment losses of goodwill or PP&E of the associate are to be calculated based on their fair values at the acquisition date.

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

- Consideration transferred -i.e., 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, eliminate only the share of investors.
- In eliminating effects of 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, investors' share of the associate's profit or loss after acquisition appropriately adjusted in order for impairment losses of goodwill or PP&E of the associate to be calculated based on their fair values at the acquisition date.

159.Under following aspects, the element of Alternative 3 appears.

- When initially recognized, transaction costs are capitalized.
- When 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 associate.
- Indirect holding of other associate's share through associates are ignored.
- In the case that an associate holds investor's shares, it is not treated as a treasury stock.

SUMMARY

160. This chapter suggests the new dimension, "scope of group," to define the underlying concepts of the equity method and three concepts of the equity method are established so that the equity method accounting becomes more internally consistent.

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

162. Comparing the current IAS 28 with the alternatives, the current IAS 28 contains many inconsistencies.

163. In addition to the issues mentioned in this chapter, we provide more application examples of three alternatives in appendix 2.

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

164.As mentioned in "Equity Method in K-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 since 1998, 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 made 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.

165.The experience of Korea could provide insights to the IASB in its research project for amending IAS 28 and the deliberation of exposure draft of IAS 27.

HISTORY OF EQUITY METHOD IN K-GAAP

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

167.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 are not required to be presented separately from other financial assets in the stand-alone financial statements.

168.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 (2) in the stand-alone financial statements.

169.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 significance 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.

170.However, as the equity method was applied to the stand-alone financial statements, diverse issues

arose in the practice which could not be solved by the above three high-level principles. Therefore, the Financial Supervisory Services (FSS) of Korea announced Interpretation No. 45-59, guidance for various accounting treatments regarding the equity method, in 1999. Interpretation No. 42-59 included detailed criteria for assessing significant influence, requirement on an accounting treatment for the difference between the consideration paid and the fair value of the associate's net asset (goodwill), a detailed guidance on how to eliminate the unrealized profit or loss from transactions with associates, and an requirement on accounting treatment when investor' ownership interest of the associates changes.

171. 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 responding to the inquiries on the equity method, and FSS also provided a large number of responses to consultations from companies.

172. 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.

173. 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.

174. To address the requests for practical guidance, the IASB is currently working on three amendment projects of the equity method18. 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.

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

176. Hereafter, we would like to share Korea's experience on the following issues - equity method for associates under K-GAAP, equity method for subsidiaries under K-GAAP, limitations of equity

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[18] IASB is working on three amendment projects in the equity method as follows: 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. Also, IASB issued *ED Equity method in separate financial statement* in December 2013.

method as one-line consolidation, and expected issues when the equity method is allowed in separate financial statements, which are based on the Korea's experience in the equity method.

EQUITY METHOD FOR ASSOCIATES UNDER K-GAAP

Accounting when the associates issue preference shares[19]

177. The accounting treatment for the preference shares mentioned on 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.[20] 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 the 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.

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

179. 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 share (30% of voting rights) and convertible redeemable

[19] 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 purpose, discussions in this paper are limited to the accounting issues about preference shares, which is most common equity instrument other than ordinary share.

[20] 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."

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 Year 1, Company B's net asset is CU 0.

Upon liquidation, preference shareholder 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 A recognize Company B's loss?

180. 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.[21] Therefore, accounting treatments can be driven from IAS 28(2011) variously depending on how to define Company A's equity in the example above. In the above example, three alternatives are possible as follows:

- *Approach 1* is that investor's share is just defined as the ownership interest of investor without considering the liquidation preference. Thus, the investor (Company A) recognizes Company B's net profit or loss to the extent of A's ownership interest (i.e. 30%) only. Then, the investor recognizes loss of CU30 (CU100*30%) in year 1, and, a profit of CU45 (CU 150*30%) in year 2. As a result, carrying value of the associate is CU 115 (CU100-CU30+CU45) in A's financial statement at the end of year 2.

- *Approach 2* is that investor's share has 100% obligation to associate's loses. Therefore, the loss of the associate is fully attributable to the ordinary shareholders 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 investor recognizes a profit of CU45 (CU150*30%) at the proportionate of its ownership interest. As a result, carrying value of the associate is CU 45(CU100-CU100+CU45) at the end of year 2.

- *Approach 3* is that the investor's share has 100% obligation to associate's loss, and 100% right to associate's gain to the extent of the associate's cumulative losses. Thus, associate's loss is fully attributable to the ordinary shareholders. Associate's gain is fully attributable to the ordinary shareholders until the associate's accumulated losses become zero; after the accumulated losses are fully recovered, investor recognizes profit at the proportionate of its ownership interest. In the example, the Company A (investor) recognizes the loss amounting to CU100, 100% of net loss in year 1, and the Company A recognizes CU115

[21] 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. "

(CU100*100%+50*30%) in profit in year 2. As a result, carrying value of associate B is CU115 (CU100-CU100+CU115) at the end of year 2.

- Consequently, the results of equity method of Company A are quite different under the three approaches as below:

	Approach 1	**Approach 2**	**Approach 3**
Common shareholder's share	Only ownership interest	Loss – 100%	Changes in accumulated deficit – 100%
		Profit – 30%, at the portion of ownership interest	Changes in retained earnings– 30%, at the portion of 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 B	CU 115	CU 45	CU 115

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

182. We provide a simple example in the above. But the real cases could be more complex. K-GAAP provides specific guidance even for more complex situation where the investor has both ordinary and preference shares.

183. Assuming that the associate issues preference shares when an investor owns the both the ordinary and the preference shares of the associates. When applying equity method on the associate, under K-GAAP, it is required to divide the associate's net asset 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, full participating or partial participating rights on dividends, the equity method cannot be applied without the adjustment of 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: [22]

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[22] The results of applying K-GAAP to Example 4.1 are summarized below.

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

Preference shareholders equity = equity of preference shareholder/(equity of preference shareholders + equity of common shareholders) * total equity of associate
Case II. When preference shareholder has the right of liquidation preference.

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

184. 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, we would like to recommend that the IASB needs to consider establishing specific guidance on IAS 28 for situations when the associate issues preference shares, and when the investor holds both of associates' preferred and ordinary share.

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

185. Although preference shares are classified as equity under K-GAAP, IAS 32/IFRS 9 requires the issuer to classify the 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 the preference shares when assessing whether it has significant influence over the issuer, and does not consider how the stocks are classified by the issuer.

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

	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)

recognizes the dividend as interest income, not an adjustment for the profit or loss and the change in the net asset of the equity accounted investment.

187.In addition, this inconsistency in the classification of the preference shares between the investor and the associates 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, it should be considered how significant influence is assessed when the investor holds preference shares which are classified as debt instruments with voting rights.

188.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 in regards to the contradiction between IAS 28 and IAS 32/ IFRS 9 is needed.

Questions to constituents

4.1 Do you have any experience on the preference shares in equity method accounting in your jurisdiction?

4.2 In relation to preference shares, do you think additional guidance need to be addressed on IAS 28?
If you do not agree, please explain why.

4.3 Do you agree that the additional guidance is needed on the equity method for various classes of equity instrument?

Impairment of associates and reversals

189.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 cash flow from dividends following IAS 36.

c) Impairment loss recognized for investments in associates is not allocated to the underlying

assets of the associates.

d) The impairment loss of investment in associates could be reversed in full.

190. As described in Paragraph 131~140, 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, which regards the investment in associates as a financial asset. However, it also has the consolidation concept, since the impairment test according to IAS 36 is the accounting for the associate's asset group.

191. K-GAAP's accounting treatment for impairment of associate 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 believed 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 accounting under K-GAAP is different from IAS 28.

a) When there are unamortized fair value adjustments or goodwill, the impairment loss is allocated to goodwill first.

b) The reversal of impairment loss is allowed only when the impairment loss was allocated to goodwill.

192. By taking a simple example, let us compare IAS 28 and K-GAAP the impairment accounting on equity accounted investment.

Example 4.2

<table>
<tr><th colspan="2">Facts</th></tr>
<tr><td colspan="2">Company A has paid CU 100 for 30% interest of Company B and obtained significant influence on Company B.
The net book value and fair value of Company B is zero at acquisition date.
The entire consideration for investment is allocated to goodwill.</td></tr>
<tr><td colspan="2">Year 1
Total investment amount shall be recognized as impairment loss due to the significant decline in sales of the associate (impairment indicator) and the recoverable amount of zero as a result of impairment test.</td></tr>
<tr><th>IAS 28</th><th>K-GAAP</th></tr>
<tr><td>Impairment losses are not distributed to goodwill, but regarded as the deduction from</td><td>The impairment loss is distributed to goodwill.</td></tr>
</table>

the book value of the investment on the associate	
Year 2 Company B's net profit is zero, and foreign currency translation reserve in other comprehensive income ("OCI") of CU 100 is recognized. The business of Company B has recovered, and the impairment indicator no longer exists.	
IAS 28	**K-GAAP**
The valuation on equity-account investee in OCI of CU 30 and reversal of impairment loss CU 100 is recognized.	The valuation on equity-account investee in OCI of CU 30 is recognized. However, no reversal of impairment loss is recognized.

193. The IASB also considered the same accounting treatment of impairment loss 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 recognises." 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.

194. 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 investor's business like subsidiaries. However, the allocation of impairment loss is differently applied 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 does not match with the concept of initial recognition of both investment – i.e. subsidiary and associate. The acquisition cost for associates is allocated to goodwill at initial recognition as the acquisition cost for subsidiaries is, and the nature of associates' goodwill is not different from the subsidiaries' goodwill. This difference in the impairment accounting between associates and subsidiaries seems inconsistency between standards.

195. Another point to be considered is the inconsistency between IAS 39 and IAS 28 in impairment accounting, though both of them are the measurement basis accounting. IAS 39 does not allow the reversal of impairment in investment in AFS equity instrument to profit or loss but rather the recovery of fair value is recognized in other comprehensive income, while the reversal of impairment in associates are recognized in profit or loss.

196. We consider that the impairment accounting in associates shows apparent mixed viewpoint of the IASB. Therefore, it should be revisited based on the IASB's viewpoint on equity method

Allocation of impairment loss

197. 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 was 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 for accounting under IAS 28 and K-GAAP, we have provided an example as below.

Example 4.4

Facts

Company A acquired Company B as an associate by obtaining 30% of Company B's share at the beginning of 2001. In 2001, Company B reported profit of CU200, 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.

- 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

198. Under IAS 28, the investor's share of 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 other comprehensive income is still presented on the investor's statement of financial position.

Equity Method: Share of Other Net Asset Changes

199. 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. After numerous discussions, *ED/2012/3 IAS 28 Equity Method: Share of Other Net Asset Changes* was tentatively published at IFRIC meeting in March 2014 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 recognised 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

200. Though the background of the IASB's final decision (i.e. recognizing other net asset changes as equity) is not clearly stated which viewpoint (consolidation or measurement) is applied, the proposed ED is consistent with Alternative 1 that we proposed in Chapter 3. In other words, it seems that the IASB considers this case as a transaction within a group, which is different from the viewpoint of many other accounting treatments in IAS 28.

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

202. When changes in the equity is reported by associates (including capital reduction, stock dividend, and capital reduction without refund), the investor's ownership interest of 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.

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

Example 4.3

Facts

- An associate issued new shares only to shareholders other than the investor.
- The associate's net asset increases from CU100 to CU140.
- The investor's interest decreases from 30% to 25%

Effect of dilution

The investor's share of the associate's net asset before the issuance of new shares: CU100* 30% = CU30

The investor's share of the associate's net asset after the issuance of new shares: CU140* 25% = CU35

As a result of issuance of new shares by the associate, change of CU5 occurs.

This change amount has the same nature as disposing 5% of share to other shareholders; therefore it is recognized as profit or loss on disposal under K-GAAP.

However, this change amount is recognized as equity under *ED/2012/3 IAS 28 Equity Method: Share of Other Net Asset Changes*.

204. 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.

205. However, the accounting treatment proposed in the IASB's ED differs from that K-GAAP and major accounting firms. Therefore, significant impact is expected if the ED is finalized as the final standard.

206. 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 a consistent application of the equity method.

207. 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.

Cross-holding interest

208. 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 (i.e. , Company A and Company B owns 30% of the other entity's share respectively.) and circulation of ownership (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).

209. 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.

210.Therefore, accounting for the elimination of internal transactions within a group could be applied by analogy in accordance with IAS 28.27 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.[23] K-GAAP provides the guidance for the cross-holding – i.e. full gross up method without elimination.

Question to constituents

4.3 This report includes the practical issues which are not defined or unclearly stated issues in IAS 28(2011).

Do you agree that the described issues should be defined or clearly stated in IAS 28(2011)?

If not, please provide us the reasons that you do not agree.

4.4 Is there additional accounting treatment that IAS 28 needs to consider that has not been addressed in this report? If so, which additional issue needs to be addressed?

EQUITY METHOD FOR SUBSIDIARIES UNDER K- GAAP

211.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 statement but only the stand-alone financial statements24, the KASB purported to show the effect of consolidation in the stand-alone financial statements.

212.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.

213.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.

214.The equity method accounting for subsidiaries in K-GAAP aligns net profit or loss and net asset of

[23] For details, please refer to International GAAP 2013 published by Wiley. (p. 772 ~ 777)

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

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, on 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 introduce only for the equity method for subsidiaries. .

214.1. First, elimination of unrealized profit/loss in downstream transactions. The unrealized profit or loss that occurs through downstream transaction 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.

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

214.3. Third, the changes in subsidiary's equity due to the issuance of new shares and other equity transactions without changing the relationship. 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.

214.4. 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 will be 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.

214.5. 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[25], the 'partial-step up' approach should be applied for additional acquisition of shares of the associate, whereby goodwill is calculated on the incremental interest acquired as a residual after valuing the incremental share of identifiable net assets at fair value.

215.The table below summarizes the differences between the equity method for subsidiaries and for associates under K-GAAP.

Table 4-2. 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
Associates become subsidiaries by additional acquisition	Acquisition method	Partial step-up

216.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.

216.1. 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 is recognized as OCI or as profit or

[25] For the comparison of equity method for subsidiary and associate, we assume that the case when the significant influence does not change. In stand-alone financial statement under K-GAAP, the change in control is not considered when the equity method is applied in subsidiary before Phase III.

loss. If this were a case for an associate, profit or loss would be reasonable. However, since the AFS securities are sold to subsidiaries, the group continuously holds the AFS securities; therefore, the gain or loss on disposal should not be recognized in consolidation. Also, the AFS securities would be revalued at fair value continuously. Therefore, in applying the equity accounting, the gain or loss on disposal should not be recognized as profit or loss for subsidiaries. (KQA 2006-015).

216.2. Case 2. If a subsidiary owns parent's shares, it shall be considered as treasury stock even when applying the equity method. Then, the gain or loss from a disposal of the treasury stock would be recognized as equity. However, if an associate sold the investor's shares, then the gain or loss from the transaction should be accounted for as a profit or loss from disposal of FVTPL securities. (KQA 2007-007)

Question to constituents

4.5 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?

4.6 Do you agree with distinguishing the equity method for subsidiaries from that for associates? Please explain why or why not.

LIMITATIONS OF EQUITY METHOD AS ONE-LINE CONSOLIDATION

217.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.

218.The most fundamental limitation can be found at the case where the associate's carrying value is below zero. K-GAPP 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.

219.Secondly, when eliminating the internal transactions, 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.

220.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

221. In November of 2013, the IASB announced an Exposure Draft which allows the equity method in the separate financial statements. This is not the first time that the IASB has considered to allow the equity method in the separate financial statements.

222. 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 did not elaborate on what made the IASB change the decision in the ED.

223. It may also cause a number of issues when the equity method is allowed in the separate financial statements. The summary for the expected issues that the IASB should take into consideration when it allows the equity method in the separate financial statements is as follows :

224. First, considerations on what is the objective of the separate financial statements and what information should be provided through the separate financial statements.

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

224.2. In other word, investments in subsidiary and associate are viewed as a financial asset (measured at fair value or cost), outside of the group in the separate financial statements.

224.3. However, as suggested by the current ED, if equity method is allowed for subsidiary, associate and JV investment, and as explained in Chapter 3, the scope of group is expanded to investor's share for investee, and therefore, the concept for the separate financial statements will be confusing along with the purpose of the separate financial statements.

225. Second, it shall be considered whether the separate financial statements which apply the equity method on subsidiaries and associates will provide more valuable information to the information users comparing 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 uses 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.

226.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.

226.1. As described in paragraph 230 to 235, 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, the ED suggested by IASB 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.

226.2. As previously explained in experiences of Korea, mismatch of the information is inevitable due to the limitations of 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 subsidiary equity method accounting differently from equity method that applies to associates.

227.Lastly, consideration needs to be taken into account with the fact that the majority of the countries adopted IFRS in recent years. The majority of adopters may be going through difficulties from enactment and amendment of the major standard, right after adopting IFRS.

228.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 adoption of IFRS but this is the period when the information users has painfully been adapting to the changes where consolidated financial statements became the primary financial statements and the separate financial statements that do not applied the equity method are provided. However, if the equity method is applied to the separate financial statements again, then confusion will arise again for information users to adapt to the new separate financial statements.

229. Consequently, the IASB should deliberate allowing the equity method option on the separate financial statements cautiously. Once the equity method is allowed, not only does the separate financial statements' purpose change but 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

230. We do not address all the accounting treatment under K-GAAP which IASB may wish to consider here. Korea has extensive experience in application of equity method in the stand-alone financial statements, however, we would like to focus on following three issues. Other issues are extremely technical and we can share those issues with the IASB upon request.

231. We would like to emphasize again that the listed issues herein are based on the experiences of Korea. Currently, the equity method is applied to the associates in consolidation financial statements, while the IASB is considering the application of the equity method in the separate financial statements. This means that the equity method is expanded to the separate financial statement and subsidiaries as well. In that instance, 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

232. This chapter provides empirical evidence on the relative usefulness between 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 on the usefulness of equity method and cost method in terms of value relevance of book value of equity and net income.

BACKGROUND

233. 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 for associates and subsidiaries are to be consolidated.

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

234. From a standpoint of 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 a standpoint of 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 groups firms in Korea.

235. 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.

236. In this paper, we test 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 separated 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

237. 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.

238. 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 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

239. By examining the differential value relevance of the information about Associates’ BV and NI, we can provide an additional evidence on the source of value relevance – whether the separate presentation of associates are 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.

240. This study uses the value relevance research framework originally developed by Ohlson (1995). 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

241. 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 consolidate 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.

242.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 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.

243.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 provide 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

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

$$\mathrm{MV}_{\mathrm{i,t}} = \alpha_0 + \alpha_1 \mathrm{SBV}_{\mathrm{i,t}} + \alpha_2 \mathrm{SNI}_{\mathrm{i,t}} + \alpha_3 \mathrm{SBV}_{\mathrm{i,t}} * \mathrm{LOSS}_{i,t} + \alpha_4 \mathrm{SNI}_{\mathrm{i,t}} * \mathrm{LOSS}_{i,t} + \mathrm{IND\ Dummies} + \varepsilon_{\mathrm{i.t}} \quad (1)$$

$$\mathrm{MV}_{\mathrm{i,t}} = \beta_0 + \beta_1 \mathrm{CBV}_{\mathrm{i,t}} + \beta_2 \mathrm{CNI}_{\mathrm{i,t}} + \beta_3 \mathrm{CBV}_{\mathrm{i,t}} * \mathrm{LOSS}_{i,t} + \beta_4 \mathrm{CNI}_{\mathrm{i,t}} * \mathrm{LOSS}_{i,t} + \mathrm{IND\ Dummies} + \varepsilon_{\mathrm{i.t}} \quad (2)$$

$$MV_{i,t} = \gamma_0 + \gamma_1 Adj.BV_{i,t} + \gamma_2 Adj.NI_{i,t} + \gamma_3 Adj.BV_{i,t} * LOSS_{i,t} + \gamma_4 Adj.NI_{i,t} * LOSS_{i,t} + \gamma_5 EQBV_{i,t} + \gamma_6 EQBV_{i,t} * LOSS_{i,t} + \gamma_7 EQNI_{i,t} + \gamma_8 EQNI_{i,t} * LOSS_{i,t} + IND\ Dummies + \varepsilon_{i.t} \quad (3)$$

$$MV_{i,t} = \mu_0 + \mu_1 Adj.BV_{i,t} + \mu_2 Adj.NI_{i,t} + \mu_3 Adj.BV_{i,t} * LOSS_{i,t} + \mu_4 Adj.NI_{i,t} * LOSS_{i,t} + \mu_5 EQBV_{i,t} + \mu_6 EQBV_{i,t} * LOSS_{i,t} + \mu_7 EQNI_P_{i,t} + \mu_8 EQNI_L_{i,t} + \gamma_9 EQNI_P_{i,t} * LOSS_{i,t} + \mu_{10} EQNI_L_{i,t} * LOSS_{i,t} + IND\ Dummies + \varepsilon_{i.t} \quad (4)$$

$$MV_{i,t} = \delta_0 + \delta_1 Adj.BV_{i,t} + \delta_2 Adj.NI_{i,t} + \delta_3 Adj.BV_{i,t} * LOSS_{i,t} + \delta_4 Adj.NI_{i,t} * LOSS_{i,t} + \delta_5 EQBVL_{i,t} + \delta_6 EQBVL_{i,t} * LOSS_{i,t} + \delta_7 EQNIL_{i,t} + \delta_8 EQNIL_{i,t} * LOSS_{i,t} + \delta_9 EQBVNL_{i,t} + \delta_{10} EQBVNL_{i,t} * LOSS_{i,t} + \delta_{11} EQNINL_{i,t} + \delta_{12} EQNINL_{i,t} * LOSS_{i,t} + IND\ Dummies + \varepsilon_{i.t} \quad (5)$$

$$MV_{i,t} = \rho_0 + \rho_1 Adj.BV_{i,t} + \rho_2 Adj.NI_{i,t} + \rho_3 Adj.BV_{i,t} * LOSS_{i,t} + \rho_4 Adj.NI_{i,t} * LOSS_{i,t} + \rho_5 EQBVL_{i,t} + \rho_6 EQBVL_{i,t} * LOSS_{i,t} + \rho_7 EQNIL_P_{i,t} + \rho_8 EQNIL_L_{i,t} + \rho_8 EQNIL_P_{i,t} * LOSS_{i,t} + \rho_{10} EQNIL_L_{i,t} * LOSS_{i,t} + \rho_{11} EQBVNL_{i,t} + \rho_{12} EQBVNL_{i,t} * LOSS_{i,t} + \rho_{13} EQNINL_P_{i,t} + \rho_{14} EQNINL_L_{i,t} + \rho_{15} EQNINL_P_{i,t} * LOSS_{i,t} + \rho_{16} EQNINL_L_{i,t} * LOSS_{i,t} + IND\ Dummies + \varepsilon_{i.t} \quad (6)$$

$MV_{i,t}$: Market value of equity, end of March at t+1 / beginning total asset
$SBV_{i,t}$: BV of equity in separate financial statements at t / beginning total asset
$SNI_{i,t}$: NI on separate financial statements at t / beginning total asset
$CBV_{i,t}$: BV of controlling shareholders' equity at t/ beginning total asset
$CNI_{i,t}$: NI of controlling shareholders at t / beginning total asset
$Adj.\ BV_{i,t}$: (BV of controlling shareholders' equity – Equity method applied BV of equity) at t / beginning total assets
$Adj.\ NI_{i,t}$: (NI of controlling shareholders – Equity method applied NI) at t / beginning total assets
$EQBV_{i,t}$: Equity method applied BV at t / beginning total assets
$EQNI_{i,t}$: Equity method applied NI at t / beginning total assets
$EQNI_P_{i,t}$: Equity method applied Net Profits at t / beginning total assets
$EQNI_L_{i,t}$: Equity method applied Net Losses at t / beginning total assets
$EQBVL_{i,t}$: Equity method applied BV of equity from listed associates at t / beginning total assets
$EQBVNL_{i,t}$: Equity method applied BV of equity From non-listed associates at t / beginning total assets
$EQNIL_{i,t}$: Equity method applied NI of listed associates at t / beginning total assets
$EQNIL_P_{i,t}$: Equity method applied Net Profits of listed associates at t / beginning total assets
$EQNIL_L_{i,t}$: Equity method applied Net Losses of listed associates at t / beginning total assets
$EQNINL_{i,t}$: Equity method applied NI of non-listed associates at t / beginning total assets
$EQNINL_P_{i,t}$: Equity method applied Net Profits of non-listed associates at t / beginning total assets
$EQNINL_L_{i,t}$: Equity method applied Net Losses of non-listed associates at t / beginning total assets
$LOSS_{i,t}$: dummy variable for firms reported net losses
IND Dummies: industry dummy variables based on the Korean standard industrial classification code

245. 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.

246.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 can provide 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 can provide evidence on the source of the differential value relevance with respect to net profit/loss of associates.

247.In order to test hypothesis 2, each associate was 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 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

248.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. Firm in non-financial sector.
3. All necessary financial and accounting data are available from KIS-VALUE and Fn-Guide.

249.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

250.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.

251.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.

252. 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.

253. 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.

254. 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.

255. 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.

256. 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

257.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	0.0697	0.0330	0.0030
	(1.59)	(2.44)*	(1.28)	(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***	**0.5901***
			(2.33)	(2.34)
Adj. NI			**8.2339****	**8.2664****
			(5.54)	(5.45)
Adj. BV*LOSS			0.2612**	0.2692**
			(15.87)	(8.97)
Adj. NI*LOSS			-9.8497**	-9.7967**
			(-8.62)	(-7.76)
EQBV			**0.4319****	**0.4060****
			(4.34)	(10.09)
EQNI			**4.7791****	
			(11.04)	
EQNI_P				**5.0311****
				(23.88)
EQNI_L				6.6057
				(1.49)
EQBV*LOSS			0.0179	-0.0297
			(0.11)	(-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**	Intercept	0.0030
	(9.56)		(0.05)
Adj. BV	**0.5851***	**Adj. BV**	**0.5902***
	(2.28)		(2.26)
Adj. NI	**8.2599****	**Adj. NI**	**8.2711****
	(5.38)		(5.23)
Adj. BV*LOSS	0.2330**	Adj. BV*LOSS	0.2398**
	(87.23)		(42.3)
Adj. NI*LOSS	-9.8653**	Adj. NI*LOSS	-9.8056**
	(-7.71)		(-7.00)
EQBVL	**0.6807****	**EQBVL**	**0.6745****
	(10.48)		(10.48)
EQBVNL	0.0692	**EQBVNL**	-0.0492
	(0.25)		-0.53
EQNIL	**2.6706****	**EQNIL_P**	**2.8035****
	(27.87)		(37.47)
EQNINL	**6.3120****	**EQNIL_L**	2.0495
	(7.35)		(1.38)
EQBVL*LOSS	-0.3116	**EQNINL_P**	**7.4434****
	(-1.33)		(9.84)
EQBVNL*LOSS	0.4717	**EQNINL_L**	7.4846
	(1.81)		1.35
EQNIL*LOSS	-4.7322**	EQBVL*LOSS	-0.3698*
	(-4.8)		(-2.57)
EQNINL*LOSS	-9.4212**	EQBVNL*LOSS	0.6751**
	(-4.16)		-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

258.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.

259.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

260.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:

261.First, we have reviewed the history of the equity method, and compared the equity method accounting standards among Germany, 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, USA and Korea were found to be a mixture of the two concepts without any sound reasoning.

262.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 group. " Alternative 1 regards the investee as a part of 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 a group. Therefore, under this concept, only the invested share of investee's assets and liabilities are considered to be held by the investor. In contrast, Alternative 3 does not view the investee as a part of a 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.

263.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 group, which is one of the main concepts of consolidation. 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.

264.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 till 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.

265.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

266.In this report, we showed that the new dimension, i. e. , scope of group, can 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 group. The IASB needs to deliberate about what additional alternative concepts are possible based on different dimensions.

267.In this report, we did not attempt to judge which of the alternatives can 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:

268. 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.

269. 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 it, it would never be possible to judge which concept of the equity method and which equity method accounting faithfully represents the equity-accounted investments.

270. 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 group.

271. In addition to the above contemplation, we believe, the IASB needs to explore whether the equity method is absolutely necessary. Resultant of research, the IASB may reach the conclusion that special accounting such as the 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).

272. The IASB's equity method research project should start from contemplating on these underlying problems.

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

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

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 transaction of interest income or interest expense that occurs between the investor and its associate needs to be eliminated. As a result, the diversity in practice exists on whether to eliminate interest income and interest expense when applying the equity method. Accounting firms also take different view on this issue. [26]

2. Alternative 1 and 2 developed in Chapter three require the effects of transactions with associate to be eliminated. This requirement is based on the view that an entire transaction or a portion of the transaction with associate is a transaction within a group. We believe that it is reasonable to eliminate the effects of the transaction that incurs interest income and interest expense.

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 balance from the transaction with an associate. The current IAS 28 only requires the elimination of profit and loss occurred from transactions with investee and therefore, it is understood that the related balances such as receivables, are not subject to be eliminated.

4. The illustrative examples in Chapter 3 reflect these requirements of the IAS 28 to present the application of alternatives without adjusting balances related to the transactions. However, the reason why the effects of the transaction are eliminated is that, under Alternative 1 and 2, the transaction, whether entirely or in part, is viewed as a transaction within a group. Therefore, it is also reasonable for the balance of related receivables and payables to be eliminated as well.

5. Let's take another look at Example 3.5 whether the elimination of the balance from the transaction is possible. In Example 3.5, elimination of entire effects of the transaction would be done through the following entries.

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26 KPMG and Deloitte interpret whether or not to eliminate the f effect that causes interest income and interest expense as an entity's accounting policy and EY does not see it as subject of elimination.

Alternative 1

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. However, as a result of these entries, the account receivable that was obtained from inventory sale is derecognized from investor's financial statements and inventories that were sold will be recognized again. In other words, the equity method has an impact on not only the equity accounted investment but also recognition and measurement of other assets and liabilities.

7. It is not clearly stated if it is an alternative for these problems, but IAS 28 only allows elimination from equity-accounted investments as follows.

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

8. In Example 3.6 of Chapter three, which is an example of upstream transaction, elimination of entire effects of the transaction would be done through the following entries.

Alternative 1

DEBIT	CREDIT
Account receivable 1,000	Inventories 1,000

Alternative 2

DEBIT	CREDIT

Account receivable 200	Inventories 200

9. The account payable that was obliged from inventory purchase is derecognized from investor's financial statements and the inventory held is derecognized as well.

ITEMS AGAINST WHICH THE ELIMINATION IS MADE

10. Another issue to consider 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 related internal transaction. In Example 3.5 of Chapter three, when eliminating the effect of downstream inventory sale, sales and cost of sales are eliminated and this method is coherent with Alternative 1 or 2. However, effects of the elimination is sometimes recognized as profit or loss from equity method in practice.

11. For example, elimination of related effects of a downstream transaction could be done through the following entry.

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

12. However, it is also possible to eliminate the effects by recognizing profit or loss from equity method, as in the following entry.

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

ELIMINATION IN EXCESS OF THE CARRYING AMOUNT OF THE INVESTMENT

13. In a downstream sales transaction, profit or losses from transaction with an associate is eliminated by adjusting equity-accounted investment. The amount to be eliminated may exceed the carrying amount of an equity-accounted investment. Under Alternative 1 and 2, in order to eliminate the entire effects of the transaction, even in this case, the elimination should be done by recognizing liabilities by the amount exceeding the carrying amount of the investment. However, concerns exist regarding whether the liability meets the definition of a liability under the Conceptual Framework.