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Dear Mr Park,

The Equity Method
KASB Discussion Paper No. 18

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

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

The Equity Method of Accounting in Australia

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

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

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

A Basis for the Equity Method of Accounting?

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

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

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

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

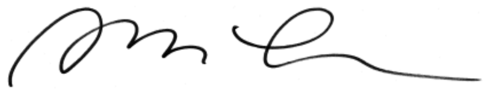
Is the Equity Method Needed?

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

The view of the AASB staff is that the numerous issues in applying the equity method could be avoided by removing the equity method from IFRSs. This would simplify the requirements of IFRSs and improve the general purpose financial statements by consolidating subsidiaries only in the consolidated financial statements and measuring investments in other entities at cost or fair value. Under this approach, the equity method of accounting would not be needed.

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

Yours sincerely,



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