Accounting for Investments in Equity: Cost or Equity Method

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Abstract

Investment in equity of other business can be accounted on the basis of nature of such investments. Investment could be i) for trading in short term, ii) for availability for sale, iii) for holding till maturity or iv) investments could be for significantly influencing or controlling the business activity of other business. The accounting treatment depends on purpose of investment and accordingly either Cost Method or Equity Method can be applied. If the purpose of investment is other than having significant influence/control in other business then it can be linked with as investment is for earning income or gaining capital income on sale of such investments. If investment is done with the object of significantly influencing/controlling business, then earning of owned enterprise would influence income statement of investing company. This study is carried on the purpose of investment and different accounting method ,disclosure in financial statements of investing company and the effects of the investments on financial position and operating results .

Key Words : Investment, Cost Method, Equity Method, Associate, Owned Enterprise, Trading Investments, Available for sale investments, Significant influence, Control , Consolidated financial statements

I. Introduction

Investment

Investment is the action or process of investing money for the purpose of profit or wealth maximization. Investments are made with the primary reasons which can be summarized as:-

- Regular source of income through interest or dividend
- Growth or appreciation in money value of investment
- Enjoying significant influence and control on other business

Cost Method

Cost Method is a based on the concept of valuation of investment at acquisition cost and such investments stays in financial statement at cost, which is not influence by variation in fair value. The recurring income by way of interest and dividend is treated as revenue and gain/loss arising on disposal is treated as revenue income/expense in a financial statement of the period of such transactions.

Equity Method

Under the Equity Method, the investment is initially recorded at acquisition cost and subsequently adjusted with investment ownership’s share in the profits and losses of owned enterprise. Such revised cost is considered as “carrying cost” of investment. Dividend received from investing company is treated as part realization of investment value and recognized as return of investment, and reduce the listed value of investment.

Through this accounting technique, we can account and recognize the profits earned by investments in other companies.

Associate

An associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

Owned Enterprise

The enterprise in which investing company has made investment by acquiring it's equity.

Trading Investments

The investments held with the intention to buy and sell for a short-term profit. These investments are reported at their fair market value. Gains and losses in transactions be included in the income statement. The unrealized holding gains or losses influences income statement and reflected in financial statements.

Available For Sale Investments

This is the investment held with the intention of frequent and un-timely sell. Available-for-sale investments cost keeps fluctuating with the changes in it's market value. The changes in value is adjusted with special account, which is called as "unrealized gain/loss in other comprehensive income", which is reflected in owners' equity. The changes in value does not affect income statement and keeps on adjusting the effects of unrealized profit/loss on account of fair market value in "other comprehensive income" statement.

Significant Influence

Significant influence is the control and authority to participate in the operating policy decisions of the owned enterprise but do not control over those policies.

Control

Control indicates the ownership of more than one-half of the voting power of other entity or composition of governing body of other entity, either directly or indirectly.

Consolidated Financial Statements

The consolidated financial statement is a statement which combines the monetary statements of all group companies as a single enterprise.

II. Review of Literature

"Assets - Choosing the Appropriate Accounting Method For Investment Securities", http://www.investopedia.com/exam-guide/cfa-level-1/assets/ choosing-accounting-method.asp, In a study the role of key financial statements in evaluating a company's performance and financial position is considered. The various classification of investment on the basis of intention to invest and nature of investment is discussed. The conclusion is drawn that these investment cannot be recorded at cost method only and it differs with intend to buy/sell period.

"The Cost Method of Accounting for Investments", http://www.accountingtools. com/cost-method-of-accounting , the study considered the circumstances under which, cost method of accounting for investment is considered as an accounting method. According to study, cost method of accounting is recommended when the investor has no substantial influence over the owned enterprise. The conclusion of the study is that cost methods of accounting are to be applied when the investor has no significant influence over the owned enterprise. In the initial recording, cost method is applied for all cases, but this requires periodical review and in case of substantial interest, equity method of accounting for investment is to be applied.

"Cost Method Vs Equity Method for Accounting of Stock Investments ",http://latestaccounting.com/accounting/cost-method-vs-equity-method-for-accounting-of-stock-investments/, In this study, the comparative application of Cost Method and Equity method of accounting for investment is considered. The methods are compared with some examples. The conclusion is that, the method of accounting depends on status of ownership in owned enterprise. When ownership exceeds 20% then cost method cannot be applied to give fair presentation of financial statements.

"Accounting Standard-13 (AS-13)-Accounting for Investment", The Institute of Chartered Accountants of India, these are the mandatory provisions for compliance with accounting practice in India. Under this standard, various accounting terms and it's concepts are given. This accounting standard requires the accounting for investment in other entity in any form whether equity or other form, when it is invested and all other point of time of holdings which may cover the concept of cost of carrying investment.

"Accounting Standard-21 (AS-21)-Consolidated Financial Statements", The Institute of Chartered Accountants of India., these are the mandatory provisions for compliance with accounting practice in India. It lay down principles and procedures for preparation and presentation of consolidated financial statements. These statements are intended to present financial information about a holding and its subsidiary(ies) as a single economic entity to show the economic resources controlled by the holding group, the obligations of the group and results the group achieves with its resources.

Accounting Standard-23 (AS-23) - Accounting for Investments in Associates in Consolidated Financial Statement", The Institute of Chartered Accountants of India, these are the mandatory provisions for compliance with accounting practice in India. Various terms and it's concepts, which are with reference to associate concerns are defined. The concept of accounting for investment under Equity Method, it's application and disclosure norms are stated.

III. III. Objective of the Study

The objectives of this study are:-

1. to study the accounting treatment and presentation of financial statement of investing company which has significant influence due to holding equity in other entity.

2. to study the accounting treatment and presentation of financial statement of group (parent) company which holds equity of other entity and have control over such other entity.

IV. Accounting Treatment On Investments

Accounting treatment of Investments is based nature of investments.

On the basis of intention and nature of investments, the investment can be classifies as:

Criteria for classification	Category of classification	Application of Accounting Method
Trading Investments	The intention is to buy/sell in short time, earn regular income, value appreciation within one year.	Cost Method
Available-for-sale investment	The intention is to carry investment for over one year.	Cost Method
Hold till maturity investment	The intention is to buy and then hold until it's pre-determined maturity date	Cost Method
Significant influence Investment	The intention is to participate in control power but holding is 20% to 50%	Equity Method
Control Investment	The intention is to exercise control and holding is more than 50%	Cost Method with Consolidation of Financial Statements

1. **Accounting of Significant Influence Investment**

In case, investments are subject to significant influence, then generally the Equity Method of accounting should be used. In equity method, the investment is initially recorded at cost method and subsequently adjustment on account of appreciation/reduction in net asset value of investment due to income(loss) of a "owned enterprise". If owned enterprise, earns income then investing enterprises should recognize income in proportionate to it's holding as it's income. In other words, income of owned enterprise is recognized as income of investing company. Dividends are not treated as income under this method. Rather, they are considered a return of investment, and reduce the recorded value of investment.

The accounting treatment can be summarized with following features:-

1. On purchase, any difference between the cost of acquisition and investing enterprise's share in owned enterprise is treated as Goodwill or Capital Reserve, as the case may be. Such Goodwill/Capital reserve should be included in the carrying amount of investment but should be disclosed separately.
2. Recognise income/loss of owned enterprise.

   On the accrual of income for a reporting period, record the share in income as per proportionate holding by inflating Carrying Value of Investment and other side as "Income/Loss from Investment". Similarly, in case of loss for a reporting period, record the share in loss as per proportionate holding by reducing Carrying Value of Investment and other side as "Income/Loss from Investment".
3. Income distribution as dividend/interest

It is recorded as return of investment and no revenue is recognised. The carrying value of Investment is reduced.

4. When investments are sold/realized

   It is recorded to show the receipt and any deficit/surplus in investment value as per books is shown as “Gains/loss on sale of Investments”

2. **Accounting of Control Investment**

   When investment is done in an enterprises, where the investing company acquires more than 50% of equity and this resulting into control over other enterprise, the accounting system gives scope for consolidation of financial statements.

   The basic features for accounting under control investments are as under:-

1. Investments in owned enterprises are accounted under Cost Method. This results into capitalizing cost of acquisition of owned company at cost, which is not influence by variation in fair value. The recurring income by way of interest and dividend is treated as revenue.

2. The investing company, prepares it’s financial statement as a standalone financial statement and further Consolidated Financial Statement of a group as a single enterprises covering all such controlled business entities.

3. In preparing consolidated financial statements, the financial statements of the investing enterprise and owned enterprises should be combined on following parameters:-

- a line by line basis by adding together like items of assets, liabilities, income and expenses
- Investment in owned enterprise and Equity Capital of owned enterprises be eliminated,
- Any surplus/deficit in financial statement in assets/liabilities be adjusted as Goodwill or Capital reserves,
- Identify minority interest in owned enterprise and adjust in Income Statement
- Minority interests in the net assets consist of the amount of equity attributable to minorities at the date on which investment in an owned enterprise is made and the minorities’ share of movements in equity since the date.
- Unrealised profits resulting from intra-group transactions be adjusted
- In consolidation of financial statements , if those financial statements are drawn up to different reporting dates, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the investing enterprise’s financial statements.

V. Research Methodology

The study is based on secondary data and the facts and figures collected from various sources.

VI. Scope for further Research.

In this study, the accounting treatment and presentation of financial statements of investing company is considered under situations of significant influences or control on owned enterprise. In a further study, the accounting disclosure and other principles of accounting can be studied to give true and fair representation of financial statements of investing company.

VII. Conclusion

The investments are carried with the intention of earning returns as dividend/income or for wealth maximization. If such investment is not resulting into significant influence in owned enterprise, then accounting is done under Cost Method. An investment which results into significant influence in "owned enterprise" then Equity Method is to be followed which requires subsequent adjustment on account of appreciation/reduction in net asset value of investment due to income (loss) of a "owned enterprise". The investment which results into control over "owned enterprise", then Cost Method is to be followed alongwith the principles of Consolidation of Financial Statements. The scope of application of accounting method can be deviated in case such significant influence or control is temporary.

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