Journal of Accounting, Financial and Economic Sciences. Vol., 2(4), 117-122, 2022
Available online at http://www.jafesjournal.com
ISSN 2149-7346 ©2022
DOI: 10.61186/jafes.2.4.117

Accounting Technique for Investment Management: Cost or Equity Method

Hamid Reza Vakilifard[1*], Masume Bazrafshan[2]

[1]*Department of Accounting, Associate, Science and Research Branch, Islamic Azad University, Tehran, Iran*
[2]*Department of Accounting, Bandar Abbas Branch, Islamic Azad University, Bandar Abbas, Iran*

[*]Corresponding Author Email: vakilifard.phd@gmail.com

Abstract: The cost and equity methods of accounting are used by companies to account for investments they make in other companies. In general, the cost method is used when the investment doesn't result in a significant amount of control or influence in the company that's being invested in, while the equity method is used in larger, more-influential investments. The equity method is an accounting technique used by firms to assess the profits earned by their investments in other companies. The firm reports the income earned on the investment on its income statement, and the reported value is based on the firm's share of the company assets. The reported profit is proportional to the size of the equity investment. Here's an overview of the two methods, and an example of when each could be applied. As mentioned, the cost method is used when making a passive, long-term investment that doesn't result in influence over the company. The cost method should be used when the investment results in an ownership stake of less than 20%, but this isn't a set-in-stone rule, as the influence is the more important factor. Under the cost method, the stock purchased is recorded on a balance sheet as a non-current asset at the historical purchase price, and is not modified unless shares are sold, or additional shares are purchased. Any dividends received are recorded as income, and can be taxed as such. The equity method of accounting should generally be used when an investment results in a 20% to 50% stake in another company, unless it can be clearly shown that the investment doesn't result in a significant amount of influence or control.

Keywords: Accounting Technique, Equity Method, Investment Management.

Introduction

Determining when one entity should consolidate another can be complex. However, it is important to investors because when one entity consolidates another, it reports the other entity’s assets, liabilities, revenues, and expenses together with its own, as if they are a single economic unit. Consequently, the consolidation decision can significantly impact the reported leverage, results of operations, and cash flows of the consolidating entity. The equity method of accounting is an approach for a company (an investor) to measure investments in common stock or other eligible investments in an investee entity by recognizing its share of the net assets underlying those investments. It also requires the investor to recognize, in net income, its share of the investee’s earnings for each reporting period (Balzer et al., 2016; Roden et al., 2012).

The equity method was initially introduced as an alternative to the cost method of accounting for investments in common stock. As companies increasingly made larger investments in other companies, the use of the equity

method was expanded and deemed to be more appropriate than cost when a company is able to exercise significant influence over the operating or financial decisions of an investee. Historically, the equity method was commonly applied to investments in joint ventures. The subsequent introduction of the VIE risks and rewards model led to some entities no longer being viewed as joint ventures and instead needing to be consolidated by one of the ventures (Balzer et al., 2016; Harris & Smith, 2009; Macintosh,1991).

Today, the starting point for assessing an investment, including one in a joint venture, is the consolidation guidance. An investor in a joint venture needs to first determine if it has a controlling financial interest and, if so, would need to consolidate the venture. Some nuances have evolved in practice in the accounting for investments in joint ventures under the equity method and the accounting by the joint venture entity. When a reporting entity elects the fair value option, financial assets and financial liabilities of the entity must be measured separately at their fair values. As a result, the aggregate fair value of the financial assets may differ from the aggregate fair value of the financial liabilities. The new guidance allows the use of the more observable of the fair value of the financial assets or the fair value of the financial liabilities of the collateralized financing entity to measure both. As a result, this alternative would eliminate the measurement difference that may exist when the financial assets and financial liabilities are measured independently at fair value.

If the new measurement alternative is not elected, reporting entities will have to reflect any measurement differences between the collateralized financing entities' financial assets and third party financial liabilities in earnings and attribute those earnings to the controlling equity interest in the consolidated income statement. The equity method is an accounting technique used by firms to assess the profits earned by their investments in other companies (Balzer et al., 2016; Li Manni et al., 2016; Zanatta et al., 2016). The firm reports the income earned on the investment on its income statement, and the reported value is based on the firm's share of the company assets. The reported profit is proportional to the size of the equity investment. The equity method used to account for a company's investment in another company acknowledges the substantive economic relationship between the two entities. When a company, the investor, has a significant influence on the operating and financial results of another company, the investee, it can directly impact the value of the investor's investment. With an investment holding above 20%, the investor usually records its share of the investee's earnings as revenue from investment, which increases the carrying value of the investment.

When the investee company pays a cash dividend, it decreases the value of its net assets. Using the equity method, the investor company receiving the dividend records an increase to its cash balance but, meanwhile, reports a decrease to the carrying value of its investment. Other financial activities that affect the value of the investee's net assets should have the same impact on the value of the investor's share of investment. The equity method ensures proper reporting on the business situations for the investor and the investee, given the substantive economic relationship they have. Investment management is the professional asset management of various securities (shares, bonds and other securities) and other assets (e.g., real estate) in order to meet specified investment goals for the benefit of the investors.

Investors may be institutions (insurance companies, pension funds, corporations, charities, educational establishments etc.) or private investors (both directly via investment contracts and more commonly via collective investment schemes e.g. mutual funds or exchange-traded funds). The term asset management is often used to refer to the investment management of collective investments, while the more generic fund management may refer to all forms of institutional investment as well as investment management for private investors. Investment managers who specialize in advisory or discretionary management on behalf of (normally wealthy) private investors may often refer to their services as money management or portfolio management often within the context of so-called "private banking". The provision of investment management services includes elements of financial statement analysis, asset selection, stock selection, plan implementation and ongoing monitoring of investments. Coming under the remit of financial services many of the world's largest companies are at least in part investment managers and employ millions of staff. The term fund manager (or investment advisor in the United States) refers to both a firm that provides investment management services and an individual who directs fund management decisions. Evercare's Investment Management businesses comprise a set of companies, each highly-focused and attuned to serve the specific needs of their respective clients with customized investment advice and management expertise. The principal partners of each Evercare investment management company own direct or indirect equity stakes in their operations.

This ensures that our investment teams maintain their entrepreneurial focus and that their business interests remain aligned with the short-term and long-term interests of our clients (Balzer et al., 2016; Jaffe & Irizarry, 2014; Macintosh, 1991; Li Manni et al., 2016; Jordan et al., 2015).

Materials and Methods

The ability to select those investments that will provide the most benefit to a community is fundamental to good government. Over the past decade the practices that have been adopted by governments and businesses to shape their investments and support investment decision making have become increasingly complex but failed to focus on the real need for an investment or the benefits expected to be delivered. The Victorian Government has therefore restructured and simplified its practices with the aim of providing decision-makers with more certainty that any investment they are considering will succeed. In other words, is it the right thing to be investing in and it will be implemented as planned? The Department of Treasury and Finance (DTF) has developed this brief Investment Management summary document for Victorian government departments and agencies to use as part of its investment decision-making process. It is intended to provide users with a basic summary of some of the key steps and practices that need to be undertaken when embarking on an investment decision. The Investment Management Standard (IMS) is a collection of simple, commonsense ideas and practices that help organizations to direct resources to deliver the best outcomes. When first developed the IMS was used to help shape individual investments. Today, its uses have broadened to the point where it can now support all the primary investment decision-making functions of an organization. Investment Management can be used to undertake the following 7 practices: shape a new investment; priorities investment proposals; develop new policy; monitor and measure the delivery of benefits; evaluate a program of investment; refocus an organization to improve its effectiveness; and monitor an organization's outcomes. Many organizations have introduced complex and compliant processes that aim to standardize the way they work and increase their rigor in shaping new investments. These processes have often failed to properly harness the knowledge available to the organization. Central to the success of the IMS is the ‘informed discussion’. These have evolved through their use on many thousands of investments since 2004 and are now a highly efficient decision-making forum that can shape and deliver effective investments. 'Informed discussions’ have the following characteristics: Informed – they require the participation of the investor (the person who has the business problem and will be responsible for delivering the benefits) and those people with the most knowledge of the subject. Decision making – the practices are structured to address a sequence of decisions that are central to the potential investment. Plain English – the story of the investment is told in simple language and concepts that can be understood by a layperson. Evidence-based – each statement of the story must be able to be supported by evidence. Two-hour limit – discussions do not exceed two-hours in duration, which has been found to be short enough time to obtain the time commitment of senior people, and long enough to extract an agreed investment story.48 hours following – the 48 hours following the discussion is used to conclude it. During this period the decisions made are circulated and any outstanding matters are electronically discussed and resolved. Facilitated – the facilitator is responsible for extracting and telling the investment story in a way that will maximize its value to the organization and expresses the concepts in plain language; obtaining the agreement of all participants to the investment story; and ensuring that each statement can be supported by evidence.

Results

The cost and equity methods of accounting are used by companies to account for investments they make in other companies. In general, the cost method is used when the investment doesn't result in a significant amount of control or influence in the company that's being invested in, while the equity method is used in larger, more-influential investments. The equity method is an accounting technique used by firms to assess the profits earned by their investments in other companies. The firm reports the income earned on the investment on its income statement, and the reported value is based on the firm's share of the company assets. The reported profit is proportional to the size of the equity investment. Here's an overview of the two methods, and an example of when each could be applied. As mentioned, the cost method is used when making a passive, long-term investment that doesn't result in influence over the company. The cost method should be used when the investment results in an ownership stake of less than 20%, but this isn't a set-in-stone rule, as the influence is the more important factor. Under the cost method, the stock purchased is recorded on a balance sheet as a non-current asset at the historical purchase price, and is not modified unless shares are sold, or additional shares are purchased. Any dividends received are recorded as income, and can be taxed as such. The equity method of accounting should generally be used when an investment results in a 20% to 50% stake in another company, unless it can be clearly shown that the investment doesn't result in a significant amount of influence or control. In accounting, equity (or owner's equity) is the difference between the value of the assets and the value of the liabilities of something owed. It is governed by the following equation: For example, if someone owns a car worth $15,000 (an asset), but owes $5,000 on a loan against that car (a liability), the

car represents $10,000 of equity. Equity can be negative if liabilities exceed assets. Shareholders' equity (or stockholders' equity, shareholders' funds, shareholders' capital or similar terms) represents the equity of a company as divided among shareholders of common or preferred stock. Negative shareholders' equity is often referred to as a shareholders' deficit. Alternatively, equity can also refer to the capital stock of a corporation. The value of the stock depends on the corporation's future economic prospects. For a company in liquidation proceedings, the equity is that which remains after all liabilities have been paid. When starting a business, the owners fund the business to finance various operations. Under the model of a private limited company, the business and its owners are separate entities, so the business is considered to owe these funds to its owners as a liability in the form of share capital. Throughout the business's existence, the equity of the business will be the difference between its assets and debt liabilities; this is the accounting equation. When a business liquidates during bankruptcy, the proceeds from the assets are used to reimburse creditors. The creditors are ranked by priority, with secured creditors being paid first, other creditors being paid next, and owners being paid last. Owner's equity (also known as risk capital or liable capital) is this remaining or residual claim against assets, which is paid only after all other creditors are paid. In such cases where even creditors could not get enough money to pay their bills, the owner's equity is reduced to zero because nothing is left to reimburse it. To invest is to allocate money (or sometimes another resource, such as time) in the expectation of some benefit in the future. In finance; the benefit from investment is called a return. The return may consist of capital gain or investment income, including dividends, interest, rental income etc., or a combination of the two. The projected economic return is the appropriately discounted value of the future returns. The historic return comprises the actual capital gain (or loss) or income (or both) over a period of time. Investment generally results in acquiring an asset, also called an investment. If the asset is available at a price worth investing, it is normally expected either to generate income, or to appreciate in value, so that it can be sold at a higher price (or both). Investors generally expect higher returns from riskier investments. Financial assets range from low-risk, low-return investments, such as high-grade government bonds, to those with higher risk and higher expected commensurate reward, such as emerging markets stock investments. Free cash flow measures the cash a company generates which is available to its debt and equity investors, after allowing for reinvestment in working capital and capital expenditure. High and rising free cash flow therefore tend to make a company more attractive to investors. The debt-to-equity ratio is an indicator of capital structure. A high proportion of debt, reflected in a high debt-to-equity ratio, tends to make a company's earnings, free cash flow, and ultimately the returns to its investors, more risky or volatile. Investors compare a company's debt-to-equity ratio with those of other companies in the same industry, and examine trends in debt-to-equity ratios and free cash flow.

Discussion and Conclusion

The term asset management is often used to refer to the investment management of collective investments, while the more generic fund management may refer to all forms of institutional investment as well as investment management for private investors. Investment managers who specialize in advisory or discretionary management on behalf of (normally wealthy) private investors may often refer to their services as money management or portfolio management often within the context of so-called "private banking". The cost and equity methods of accounting are used by companies to account for investments they make in other companies. In general, the cost method is used when the investment doesn't result in a significant amount of control or influence in the company that's being invested in, while the equity method is used in larger, more-influential investments. The equity method is an accounting technique used by firms to assess the profits earned by their investments in other companies. The firm reports the income earned on the investment on its income statement, and the reported value is based on the firm's share of the company assets. The reported profit is proportional to the size of the equity investment (Balzer et al., 2016; Macintosh, 1991; Li Manni et al., 2016; Thompson & Hratchian, 2015; Jordan et al., 2015). Here's an overview of the two methods, and an example of when each could be applied.

As mentioned, the cost method is used when making a passive, long-term investment that doesn't result in influence over the company. The cost method should be used when the investment results in an ownership stake of less than 20%, but this isn't a set-in-stone rule, as the influence is the more important factor. Under the cost method, the stock purchased is recorded on a balance sheet as a non-current asset at the historical purchase price, and is not modified unless shares are sold, or additional shares are purchased. Any dividends received are recorded as income, and can be taxed as such. The equity method of accounting should generally be used when an investment results in a 20% to 50% stake in another company, unless it can be clearly shown that the investment doesn't result in a significant amount of influence or control. Accounting or accountancy is the measurement, processing and communication of financial information about economic entities such as businesses and corporations. The modern

field was established by the Italian mathematician Luca Pacioli in 1494. Accounting, which has been called the "language of business", measures the results of an organization's economic activities and conveys this information to a variety of users, including investors, creditors, management, and regulators. Practitioners of accounting are known as accountants. The terms "accounting" and "financial reporting" are often used as synonyms.

Accounting can be divided into several fields including financial accounting, management accounting, external auditing, and tax accounting. Accounting information systems are designed to support accounting functions and related activities. Financial accounting focuses on the reporting of an organization's financial information, including the preparation of financial statements, to external users of the information, such as investors, regulators and suppliers; and management accounting focuses on the measurement, analysis and reporting of information for internal use by management. The recording of financial transactions, so that summaries of the financials may be presented in financial reports, is known as bookkeeping, of which double-entry bookkeeping is the most common system.

Accounting is facilitated by accounting organizations such as standard-setters, accounting firms and professional bodies. Financial statements are usually audited by accounting firms, and are prepared in accordance with generally accepted accounting principles (GAAP). GAAP is set by various standard-setting organizations such as the Financial Accounting Standards Board (FASB) in the United States and the Financial Reporting Council in the United Kingdom.

As of 2012, "all major economies" have plans to converge towards or adopt the International Financial Reporting Standards (Balzer et al., 2016; Gao et al., 2015; Harris & Smith, 2009; Kindt, 2013; Macintosh, 1991; Jordan et al., 2015). Determining when one entity should consolidate another can be complex. However, it is important to investors because when one entity consolidates another, it reports the other entity’s assets, liabilities, revenues, and expenses together with its own, as if they are a single economic unit. Consequently, the consolidation decision can significantly impact the reported leverage, results of operations, and cash flows of the consolidating entity. The equity method of accounting is an approach for a company (an investor) to measure investments in common stock or other eligible investments in an investee entity by recognizing its share of the net assets underlying those investments. It also requires the investor to recognize, in net income, its share of the investee’s earnings for each reporting period. Management (or managing) is the administration of an organization, whether it is a business, a not-for-profit organization, or government body. Management includes the activities of setting the strategy of an organization and coordinating the efforts of its employees or volunteers to accomplish its objectives through the application of available resources, such as financial, natural, technological, and human resources. The term "management" may also refer to the people who manage an organization.

The equity method was initially introduced as an alternative to the cost method of accounting for investments in common stock. As companies increasingly made larger investments in other companies, the use of the equity method was expanded and deemed to be more appropriate than cost when a company is able to exercise significant influence over the operating or financial decisions of an investee. Historically, the equity method was commonly applied to investments in joint ventures. The subsequent introduction of the VIE risks and rewards model led to some entities no longer being viewed as joint ventures and instead needing to be consolidated by one of the ventures. Today, the starting point for assessing an investment, including one in a joint venture, is the consolidation guidance. An investor in a joint venture needs to first determine if it has a controlling financial interest and, if so, would need to consolidate the venture. Some nuances have evolved in practice in the accounting for investments in joint ventures under the equity method and the accounting by the joint venture entity (Balzer et al., 2016; Gao et al., 2015; Jaffe & Irizarry, 2014; Macintosh, 1991; Li Manni et al., 2016; Sabin, 1987; Talbot et al., 2015; Jordan et al., 2015).

Conflict of interest

The authors declare no conflict of interest.

References

Balzer, C., Cimino, R. T., Gor, G. Y., Neimark, A. V., & Reichenauer, G. (2016). Deformation of microporous carbons during N2, Ar, and CO2 adsorption: Insight from the density functional theory. Langmuir, 15(15).

Budkov, Y. A., Kolesnikov, A. L., & Kiselev, M. G. (2016). On the theory of electric double layer with explicit account of a polarizable co-solvent. J Chem Phys. 144(18), 4948634.

Gao, T., Blackwell, R., Glaser, M. A., Betterton, M.D., & Shelley, M. J. (2015). Multiscale modeling and simulation of microtubule-motor-protein assemblies. Phys Rev E Stat Nonlin Soft Matter Phys, 92(6), 10.

Harris, E. F., & Smith, R. N. (2009). Accounting for measurement error: a critical but often overlooked process. Arch Oral Biol, 54(1), 31.

Jaffe, A. E., & Irizarry, R. A. (2014). Accounting for cellular heterogeneity is critical in epigenome-wide association studies. Genome Biol, 15(2), 2014-15.

Jordan, C. Y., Ally, D., & Hodgins, K. A. (2015). When can stress facilitate divergence by altering time to flowering? Ecol Evol, 5(24), 5962-73.

Kindt, J. T. (2013). Accounting for Finite-Number Effects on Cluster Size Distributions in Simulations of Equilibrium Aggregation. J Chem Theory Comput, 9(1), 147-52.

Li Manni, G., Smart, S. D., & Alavi, A. (2016). Combining the Complete Active Space Self-Consistent Field Method and the Full Configuration Interaction Quantum Monte Carlo within a Super-CI Framework, with Application to Challenging Metal-Porphyrins. J Chem Theory Comput, 12(3), 1245-58.

Macintosh, N. B. (1991). Hospital accounting and information systems: a critical assessment. Aust Health Rev, 14(1), 46-56.

Roden, J., Strunz, W. T., Whaley, K. B., & Eisfeld, A. (2012). Accounting for intra-molecular vibrational modes in open quantum system description of molecular systems. J Chem Phys, 137(20), 4765329.

Sabin, P. (1987). Hospital cost accounting and the new imperative. Health Prog, 68(4), 52-7.

Simenas, M., & Balciunas, S. (2016). Ma Combining Cedilla Czka M, Banys J, Tornau EE. Structural phase transition in perovskite metal-formate frameworks: a Potts-type model with dipolar interactions. Phys Chem Chem Phys, 18(27), 18528-35.

Talbot, A. L., Dorrian, J., & Chapman, J. (2015). Using the Theory of Planned Behaviour to examine enrolled nursing students' intention to care for patients with alcohol dependence: A survey study. Nurse Educ Today. 35(11), 1054-61.

Thompson, L. M., & Hratchian, H. P. (2015). Modeling the Photoelectron Spectra of MoNbO2(-) Accounting for Spin Contamination in Density Functional Theory. J Phys Chem A, 119(32), 8744-51.

Zanatta, G., Della Flora Nunes, G., Bezerra, E. M., da Costa, R. F., Martins, A. M., Caetano, E. W., et al. (2016). Two Binding Geometries for Risperidone in Dopamine D3 Re-ceptors: Insights on the Fast-Off Mechanism through Docking, Quantum Biochemistry and Molecular Dynamics Simulations. ACS Chem Neurosci, 19(19).