FACTA UNIVERSITATIS
Series: **Economics and Organization** Vol. 17, N° 2, 2020, pp. 173 - 186
https://doi.org/10.22190/FUEO191021013S

Review Paper

INFORMATIONAL SCOPES AND THE AREA OF APPLICATION OF THE EQUITY METHOD

UDC 658.14

Vojislav Sekerez

University of Belgrade, Faculty of Economics, Serbia

Abstract. *The equity investments in other entities may result in different level of control over their activities and different consequential relationships between the investors and investees. For the purposes of valuation of the investments in associates and joint ventures, which are followed by significant influence or joint control of the investor, it is necessary to use the equity method. Its application is connected with the number of specific issues that result in a completely different accounting treatment of some business transactions in relation to the acquisition method and consolidation of subsidiaries. The aim of this paper is to analyze the key features and area of application of the equity method, which will be accompanied by the reference to some of its most obvious advantages and disadvantages.*

Key words: *significant influence, joint control, equity method, consolidated financial statements, separate financial statement.*

JEL Classification: M41

INTRODUCTION

The development of modern capital markets leads to a growing number of transactions that result in significant equity investments in other companies. Investors decide to make such investments for various reasons, so the nature of relations established and intensity of control over the investees will be determined not only by the ownership level, but also by a number of other specific factors. Accounting treatment and valuation of these investments will primarily depend on whether they have resulted in absolute, significant, joint or common control over the investee's activities. Majority equity investments, which are

Received October 21, 2019 / Revised March 02, 2020 /Accepted February 11, 2020
Corresponding author: Vojislav Sekerez
University of Belgrade, Faculty of Economics, Kamenička 6, 11000 Belgrade, Serbia
E-mail: vsekerez@ekof.bg.ac.rs

followed by the control over the subsidiaries, need to be consolidated with the use of the acquisition method.On the other hand, the equity method needs to be used to account for investments in the associates and joint ventures, which are accompanied by the investor's significant influence or joint control. Finally, minority equity investments that are not followed by significant influence of the investor (ownership interest is usually between 10% and 20%), should be valued in accordance with IFRS 9 – Financial instruments. Therefore, different levels of control and different consequential relations between the investor and investees require a different ways of accounting for investment.

The fact that the equity method is widely used in practice, which is accompanied by a specific treatment of certain business transactions during the valuation of investments, imposes the need for a detailed analysis of its features and informational scopes. Research in this paper will be focused on the basic characteristics and the way of functioning of the equity method, with special reference to the comparative analysis of differences in accounting treatment of the most important aspects of investments' valuation, those occurring from the application of equity method and acquisition method. Since the percentage of ownership interest (as a financial criterion) serves only as a starting point for determining whether there is a significant influence or joint control of the investor, in this article a detailed analysis of the key prerequisites for the implementation of the equity method will be made. Also, a reference will be made to a significant expansion of the area of application of the equity method, which occurred in the last few years due to changes in professional regulation. Finally, at the end of the paper, some of the most significant weaknesses and shortcomings of the equity method that have been noticed in practice during its application will be presented.

1. Prerequisites for the Application of the Equity Method

The equity investments in other companies can be made with different motives and in a wide range of percentage share in equity of investees. From a financial reporting angle, its percentage share represents only a starting point for determining the nature of investment and appropriate accounting method for their valuation. This means that it is necessary to take a broader approach when determining the nature of the relationship between investor and investee, in order to supplement the initial information on the percentage of ownership interest with a clear insight in the intensity of control that is actually achieved. The point is that the intensity of control (significant or absolute) and the resulting investor-investee relationship will crucially determine further accounting treatment and the way of investment's valuation. In that sense, a framework for ranking equity investments according to the percentage share has been established in accounting regulations and practice, which should provide a starting point for determining the degree of control over the investees.

According to the financial criterion shown in Table 1, investments in range from 20 to 50% of voting rights are considered as significant ownership interests and they are the initial basis for applying the equity method, but under the condition that they allow significant influence over the associate or joint control over the joint venture. Starting with the assumption that significant equity investment in most cases should allow the significant control for investor, IAS 28 - Investments in associates and joint ventures in paragrapf 16 additionally emphasizes that exercising significant influence or having joint control is the primary criterion to be fulfilled in order to apply the equity method. This means that the significant equity investment is only the starting point for exercising significant influence, because it, by itself, is not enough since the investor must demonstrate this possibility in practice. The same standard says that "significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies" (IAS 28, 2011, par.3). Thus, having more than 20% of the voting rights of investee suggests that there is significant influence, unless it can be clearly demonstrated that this is not the case. Similarly, having less than 20% of the voting rights initially implies that there is no significant influence, unless the existence of such influence can be clearly demonstrated.

Table 1 Financial criterion for accounting treatment of equity investments

Type of equity investment	Ownership level	Control level	Applicable accounting method
Common	10-20%	Absence of significant influence	Cost method (initially) and fair value
Significant	20-50%	Significant influence	Equity method
Majority	More than 50%	Control	Consolidation (acquisition method)

Source: Hoyle, J.B., Schaefer, T. F, & Doupnik, T.S. (2011). Advanced Accounting. 10th edition, New York: McGraw-Hill/Irwin, p. 6. (table was modified by author)

Therefore, having a significant ownership interest in practice does not guarantee the exercise of significant influence, nor does having a majority ownership interest of more than 50% of voting rights always guarantee the control over an entity. IAS 28 in paragraph 6 offers a list of criteria whose fulfillment may indicate that there is significant influence. None of them should be used solely, as a basis for conclusion, but should be viewed simultaneously to determine the investor's ability to exercise significant influence over the investee. These criteria are: representation on the board of directors or equivalent governing body of the investee; participation in policy-making processes (including participation in decisions about dividends); significant transactions between the entity and its investee; interchange of managerial personnel and provision of essential technical information (IAS 28, 2011). It is interesting to say that, within FASB ASC 323, the above criteria are joined by one additional: extent of ownership by the investor in relation to the size and concentration of other ownership interests in the investee (Hoyle, 2010).

It is noticeable that the ability to exert significant influence, as a primary criterion for the application of the equity method, is obviously very broadly and vaguely defined, which opens the room for subjective judgment and free interpretations in practice. The range of 20-50% of voting rights has been prety much arbitrarily established, merely to provide clear and consistent guidance for financial reporting purposes. However, the investor's ability to exercise significant influence, which should be the consequence of the significant ownership interest, often does not exist in practice. Therefore, if the ability to exercise significant control is not manifested or, oppositely, if there is control over the investee, equity method should not be applied, regardless of the fulfillment of the initial financial criterion that voting rights are in range between 20% and 50%. For example, the equity method should not be applied (regardless of the fulfillment of the initial financial criterion) in situation when an agreement between investor and investe requires suspension of investor's significant influence or when investor fails in attempts to obtain representation on the investee's board of directors of (Hoyle, 2010).

In the examples above, the investor should treat his ownership interest as common and use the fair value for its further valuation, in accordance with IFRS 9 - Financial instruments. In contrast, in situations where an investor with 50% or less of voting rights is capable of establishing control over its investee, it is necessary to apply the acquisition method instead of the equity method and to consolidate controlled entity. In such situations, control is achieved through contractual and other arrangements that specify decision making power. Therefore, some companies (Walt Disney Company, for example) have been required to reclassify their former equity method investees as so called variable entity investees and to consolidate them.

Contrary to the examples above, which limited the application of the equity method, despite the fact that investors held 20-50% of voting rights, there are also situations where applying the equity method is necessary, even though investors own less than 20% or more than 50% of voting rights in investee. For example, AT&T, Inc. used the equity method to account for its 9% equity investment in America Movil, a wireless provider in Mexico. This is explained by the fact that AT&T is a member of the consortium that holds voting control of the America Movil, providing it with significant influence. The other extreme, which also makes it possible to apply the equity method, is a situation where investor owns majority ownership interest, but the veto power of minority shareholders prevents him from exercising control over that company. Similarly, the lack of control can also occur in situations where the majority owner agrees to share management and control with another investor (Hoyle, 2010).

Hence, the arbitrariness of the starting financial criterion of 20-50% of voting rights imposes the need for a broader approach when determining the existence of investor's significant influence, which is additionally aggravated by the lack of clarity and precision of the supplementary criteria, offered by the IAS 28 or ASC 323. The previous discussion suggests that the determination of the existence of significant influence is followed by a number of case-specific characteristics and may be accompanied by a high dose of subjectivity.

Finally, it is important to say that, due to the lack of space, in this place we will not go into more detail on the concept of joint control, whose existence is a crucial criterion for the application of the equity method in the case of joint venture investments. It should be only emphasized that determining whether an investor engages in joint control brings with it no less difficulties compared to determining the existence of significant influence over the associates. The problem of defining the concept of joint control is addressed by the IFRS 11 – Joint arrangements, which emphasizes that "joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control" (IFRS 11, 2011, par. 7). Accordingly, in a joint arrangement, no single party controls the arrangement on its own, but all the parties (or a group of the parties) control the arrangement collectively by acting together to direct the relevant activities that significantly affect the variable returns of the arrangement. In the case of joint ventures (as a type of joint arrangements which is different from joint operations according to IFRS 11), joint control allows parties' rights to the entity's net assets and obliges them to use the equity method (Leitner-Hanetseder et al., 2014).

2. BASIC CHARACTERISTICS OF THE EQUITY METHOD

As we have previously emphasized, the investor makes a significant ownership interest when owning 20-50% of shares in the investee's equity, which is often the basis for exercising significant influence over its business. For the purpose of counting for investments in associates or joint ventures, over which the investor exercises significant influence or joint control, it is necessary to use the equity method, according to IAS 28. It is the accounting method whereby the investment is initially recognized at cost and adjusted after the acquisition date for the changes in the investor's share of the net assets of the investee (IAS 28, 2011 par.3). As a consequence, the investor's profit and loss statement will include the related share of the profit or loss of the investee, and its other comprehensive income includes its share of the other comprehensive income of the investee. In contrast, an acquisition method is used for accounting for majority ownership interests (that allow parent's control over a subsidiary) and reporting on them in the consolidated financial statements. Accordingly, different levels of control and resulting relationships between investors and investees require the application of different accounting methods for equity investments' valuation and consolidation.

The initial recognition is only the first step in applying the equity method and it is carried out in the amount of the cost of the acquired equity share. This means that, unlike the majority ownership interests, which are initially measured at fair value, the costs of significant ownership interests also include any transaction costs that are associated with the acquisition (stock exchange fees, costs of legal and other services etc.). In anticipation of above average returns, when buying an equity share, investor may decide to pay more than the share of the net fair value of the identifiable assets and liabilities of associate or joint venture. This difference between the higher acquisition costs and the lower fair value of the related portion of the investee's net assets represents goodwill, which is included in the carrying amount of the investment (as its integral part) within investor's Statement of financial position. Therefore, goodwill is not disclosed separately, as it is the case when acquiring subsidiaries, and not tested for impairment, but subject of that test is investment as a whole. On the other hand, if the carrying amount of the investment is lower than the related portion of the fair value of the investee's net assets (a lower amount is paid), the investor on that occasion made an income, which should be disclosed in its Statement of comprehensive income (Škarić-Jovanović, 2014).

The essential idea underlying the equity method is that the subsequent investment's valuation should present the close relationship that has been established between the investor and investee, as a result of significant or joint control. Therefore, in accordance with this method, the value of equity investment is constantly changing in line with the changes in net assets of investee, so it can always reflect the associated portion of investee's net assets in the investor's Statement of financial position. These changes are most often caused by: the subsequent investment or withdrawal of a portion of the investor's ownership interest, the profit or loss of the investee or changes in the fair value of the investee's assets. Consequently, through the changes in the value of its equity investment, the investor actually bears full responsibility for the results of associates or joint ventures, given that it exercises a significant influence on their business.

In this regard, the subsequent equity investment in associates or joint ventures increases their net assets and, therefore, the amount of investor's participation, regardless of whether there will be a change in the percentage of ownership interest. If a subsequent investment turns significant ownership interest into a majority interest, the investor should discontinue the use of equity method and the accounting for the investment is further carried out in accordance with IFRS 3 - Business combinations and IFRS 10 - Consolidated financial statements. On the other hand, reduction of ownership interest in the associates or joint ventures, whereby the investor retains significant influence and continues to use the equity method, implies that it should reclassify to profit and loss statement the proportion of the gain or loss that had previously been recognised in other comprehensive income, relating to that reduction in ownership interest (IAS 28, 2011, par.25). The application of the equity method should be also discontinued if the investor sells part of its ownership interest, whereby the retained remaining interest does not allow exercising significant influence over the investee, that is, when the investee ceases to be an associate or joint venture. If the retained ownership interest is a financial asset, it should be measured at the fair value, in accordance with IFRS 9 - Financial instruments (IAS 28, 2011, par.22).

As we have noted above, the associated portion of the investee's profit should be recognized as revenue from investment in the investor’s Statement of comprehensive income, while the value of the equity investment also increases by the same amount in the Statement of financial position. This amount is derived by applying a percentage of the ownership interest to investee’s profit after taxation. In the case that an associate or joint venture incurs a loss, the investor’s participation would be proportionally impaired. This approach of investment’s valuation fully reflects the basic idea of the equity method and it is one of the key differences with respect to the acquisition method, where only a portion of the subsidiary's profit (dividend paid) is recognized as income from the parent's participation. IAS 28 in paragraph 11 emphasizes that revenue recognition, based on the distribution of investee’s profit (as with the acquisition method), does not have to be an adequate measure of income earned by an investor, because the dividend distribution policy itself often has little to do with the performance of investees. Therefore, it is considered that the application of the equity method offers more useful and relevant information on the real value of investments, net assets and profit or loss of investor (IAS 28, 2011). In this regard, it is important to emphasize that the equity method and the acquisition method differ not only in determining the amount of investor revenues, but also in the moment of their recognition. Namely, the equity method implies that the related investor’s revenue is recognized in the same accounting period in which the profit of the investee was earned, while the acquisition method requires that the parent's revenues (dividend income) be recognized and reported only in the following year relative to the year in which the distributed profit of subsidiary was earned (Škarić-Jovanović, 2014).

Hence, unlike the accounting treatment of dividend with parent companies, which is recognized as investment’s income in the amount charged, the equity method requires that the value of the investor’s participation should be reduced by amount of the dividend received. This is completely in line with the basic idea of the equity method that any change in the amount of the investee's net assets simultaneously changes the amount of the related investor's proportionate interest. Given that dividends paid reduce the investee's net assets, it is correct to reduce the amount of investors participation by amount of received dividend. In addition, the investor has previously already recognised income and increased the amount of its investment by the related part of the investee’s profit (of which dividends are an integral part), so treating the dividend as income would double them. Therefore, according to the equity method, dividends are not income, but the conversion of part of the equity investment in cash (Hoyle et al., 2011).

The amount of the net assets of an associate or joint venture may also change in situations where the fair value of certain items of their assets changes (IAS 28, 2011, par.10). In such cases, achieved unrealized gains/losses are recognized in the investee's other comprehensive income, as a component of equity. Considering the fact that in the spirit of the equity method, the investor participates not only in the investee's profit or loss, but also in its other comprehensive income, these changes in the amount of the investee's net assets consequently change the amount of the investor's participation. Accordingly, in the case of unrealized gains on the change in the fair value of the investee's assets, both the amount of investor's share and its other comprehensive income increases proportionately. On the other hand, the proportionate portion of unrealized losses (in the case of a decrease in the fair value of the investee's assets) will simultaneously reduce the amount of the investor's interest and its other comprehensive income (Škarić-Jovanović, 2014).

Finally, another reason for the subsequent decrease in the amount of equity investment are the internal gains/losses that arise as a result of making deliveries or providing services between the investor and its associates or joint ventures. According to the equity method, these internal results are treated as unrealized, because the investor and investee are viewed as a single entity. The recognition of the mentioned results is deferred in the investors' financial statements until their external realization to third parties. Therefore, at the time of preparation of the financial statements, the investor simultaneously reduces the amount of its investment and the amount of the investment's income for the part of that unrealized profit, which is proportional to its ownership interest. In contrast, the existence of unrealized losses would entail a simultaneous increase in the amount of the investor's participation and its income for the related part of loss (Škarić-Jovanović, 2015).

It is important to emphasize that the internal results are viewed from the perspective of investee, as they are presented in full in its individual financial statements, without the need for elimination. At the same time, they affect the amount of disclosed result, as a basis for subsequent adjustment of investor's participation. Therefore, the internal profit will occur when the investee makes a delivery (or provide service) to the investitor with gain (uprstream transaction), or when the investor makes a delivery to the investee with loss (downstream transaction), because then the assets were purchased at a price below their costs and the investee's income was unjustifiably increased by this amount of internal profit. In the case of internal losses, the mentioned transactions will proceed in the opposite direction and with opposite effects. Therefore, starting from the fiction that investor and investee are one single entity, the internal results must be eliminated when calculating the amount of equity investment and income from it in investor's financial statements. Also, the fiction of a single entity and the resulting need for elimination of internal results is very close to the principles of the full consolidation of parent company and subsidiaries, whereby the acquisition method is used. However, despite the similarity noted above, there is also another important difference between the equity and the acquisition method. Namely, the application of the equity method does not require complete consolidation of assets, liabilities, equity, revenues and expenses, as is the case with the acquisition method, so internal results are not eliminated from the value of inventories (which are not an object of consolidation), but the investor's participation is adjusted for their amount.

It should be noted that entities that are exempt from the obligation to prepare consolidated financial statements (in accordance with IFRS 10) are not required to apply the equity method. This method, also, does not have to be applied when all of the following factors are present:

- The entity is a wholly or partially-owned subsidiary of some other entity, and its other owners (including those without voting rights) are informed about it and do not object that equity method is not applied;
- The entity's debt or equity instruments are not traded in a public market;
- The entity did not fill its financial statements with a securities commission, with the aim of issuing debt or equity instruments in a public market;
- The ultimate or any intermediate entity's parent company already prepares public financial statements that comply with IFRS (IAS 28, 2011, par. 17).

3. Expanding the Scope of Application of the Equity Method

In recent years, certain changes in professional regulation have led to a significant expansion of the scope of application of the equity method. Namely, the IASB (*International Accounting Standards Board)* has decided that this method, after several years of pause, can be used again from 2016 as one of the options for equity investments' valuation in separate financial statements. It is important to say that the separate financial statements are individual reports prepared by the parent companies and investors (with joint control or significant influence over the investees), primarily with the purpose of disclosing the value of their investments in the equity of these entities. IAS 27 – Separate financial statements, in this respect, explicitly emphasizes that the financial statements of entities that do not have investments in subsidiaries, associates or joint ventures are not separate financial statements (IAS 27, 2011, par. 7). This means that holding the majority and significant ownership interests in other companies, followed by the absolute or significant control over their businesses, is a prerequisite for the preparation of separate financial statements. On the other hand, entities that are exempted from the obligation to prepare consolidated financial statements (in accordance with IFRS 10) and entities that are exempted from the obligation to use the equity method (in accordance with IAS 28), can prepare separate, as their only financial statements. Consequently, we may conclude that IAS 27 does not prescribe which entities are required to prepare separate financial statements, but they are prepared when the parent companies and investors voluntarily opt for it or when they have such an obligation in accordance with national regulations. Therefore, separate financial statements are reports that *can* (but, also, don't have to) be prepared together with consolidated or financial statements of investors applying the equity method. Otherwise, it should be said that the financial statements of investors in associates and joint ventures are not considered as a consolidated financial statements in the strict sense, because there is no complete consolidation of assets and liabilities (only equity investments are consolidated).

Therefore, although in a broad sense separate financial statements belong to the category of individual financial statements, the specific requirements of their users make it essential to differentiate them substantially from all other individual financial statements, prepared by the entities that do not have majority or significant ownership interests. It is important to emphasize that the growing importance of consolidated financial statements in the conditions of internationalization of business does not diminish the need for the publication of individual or separate financial statements of companies, which are the holders of majority and significant investments in the equity of other entities. Separate financial statements of parent companies and investors primarily serve as a means of protecting the interests of users, such as owners, creditors and government bodies, which in this field often make more specific information requirements than what they expect from the consolidated financial statements. This fact has initiated the IASB to publish a particular standard - IAS 27, which explicitly addresses the issues of their preparation and presentation.

In this respect, after the revision of IAS 27 - Consolidated and separate financial statements and IAS 28 - Investments in associates in 2003, the equity method has been eliminated as a tool for valuation of investments in subsidiaries, associates and joint ventures within the separate financial statements, although it had been used for many years as one of the options for the purposes mentioned. At that point, companies were given the opportunity to use the cost or fair value (in accordance with IAS 39 – Financial instruments: reconition and measurement) for all investments in subsidiaries, associates and jointly controlled entities included in the separate financial statements. The IASB explained this decision by saying that the information provided by the equity method is reflected in consolidated and other financial statements of investors (especially where IAS 28 was applied), and that there is no need to provide the same information in the separate financial statements.

However, it turned out that such a decision, which was nominally motivated by a reduction in the number of options under IFRS and increased comparability of financial statements, had the opposite effect in practice. Specifically, in a number of countries, local regulators require listed companies to prepare separate financial statements and, on that occasion, use the equity method for valuation purposes. As a result, incomparability emerged, because the only difference between the financial statements prepared in accordance with national rules the financial statements prepared in accordance with IFRS was in (non) use of equity method. It turned out that this was a strong enough argument for returning the equity method to the set of allowable tools for the valuation of equity investments in separate financial statements, so in May 2012 the IASB decided to launch an initiative in this field (IASB, 2013). A draft proposal was issued in December 2013, and after discussions and opinions collected, an amendment to IAS 27 was issued in August 2014. This amendment permits that the equity method can be used again (as regulated by IAS 28) for the purposes of accounting for investments in subsidiaries, associates and joint ventures when preparing separate financial statements. After this decision, the companies had a choice between equity method, cost and fair value (in accordance with IFRS 39 – Financial instruments) for the purpose of valuation of the equity investments, but once selected option had to be consistently applied to all categories of equity investments. The effective implementation of this decision began on January 1st 2016, with early adoption permitted. Also, the IASB has ordered retroactive application of the equity method for all accounting periods from the date of acquisition, which undoubtedly increases the complexity and costs of financial statements' preparation.

It should be noted that, during this process, EFRAG (*European Financial Reporting Advisory Group*) was not opposed to returning the equity method to a set of permitted techniques for accounting for investments within separate financial statements, although it increases the number of options in IFRS and potentially reduces the comparability of financial information. EFRAG explained this by the fact that the equity method offers a relevant and useful information on the economic value of investor's net assets and profit or loss in its separate financial statements. This attitude is in line with the opinion of the IASB that "information may be relevant even if some users are already aware of it from other sources. Consequently, the fact that equity method provides information that is already reflected in consolidated financial statements does not mean that it would not provide relevant information" (IASB, 2013, par. BC8). However, while considering changes to IAS 27, EFRAG expressed concern that full retrospective application would increase the complexity and costs of preparing the financial statements for entities that opt to use the equity method to account for subsidiaries in their separate financial statements. In addition, EFRAG also considered that the IASB had not provided a sufficiently clear explanation for the treatment of differences that occur between the value of majority ownership interests in the consolidated and separate financial statements of parent companies that opt to use the equity method. These differences arise from the different accounting treatment that the equity method and the acquisition method have for transactions such as: costs of acquisition, impairment of goodwill, distribution of dividends, elimination of intercompany gains and losses etc., so EFRAG conluded that the IASB in this regard should offer an additional guidance within IAS 28 (EFRAG, 2014a).

Nevertheless, in its final report, EFRAG surprisingly softened its position and accepted all the proposed amendments to IAS 27, stating that the differences between separate and consolidated financial statements are understandable to users as consolidated and separate financial statements reflect totally different views – the view of group and the view of an individual entity. EFRAG finally considered that "following the methodology given by IAS 28 as applicable to an associate or a joint venture to account for subsidiaries in separate financial statements will not add undue complexity to the extent that it may impair reliability" (EFRAG, 2014a, p.7). Also, costs for preparers and users, incurred on that occasion, are one-off costs, which should not be significant, given the fact that application of equity method is optional. Ultimetely, the decision to make the transition to the equity method will be based on expected benefits that will arise from that change.

Finally, in addition to the possibility of using the equity method for the preparation of separate financial statements, the expansion of scope of its application was also influenced by the he adoption of IFRS 11 - Joint arrangements, which have replaced the old IAS 31 - Investments in Joint ventures since January 1st 2013. On that occasion, the equity method has replaced the proportional consolidation method for the purpose of accounting for investments in joint ventures, which also significantly increased the number of its users. This decision of the IASB was motivated primarily by reducing the number of options in standards to increase comparability with US GAAP (Ašenbrenová, 2016). Also, it should be noted that this change has caused numerous reactions in the academic and professional community. Analysis of the pros and cons of eliminating the proportional consolidation method and its effects on the practice of financial reporting and the quality of information has been performed by Demerens et al., (2014) and So et al., (2018).

4. DISADVANTAGES OF THE EQUITY METHOD

Notwithstanding the widespread use of the equity method and its positive characteristics, primarily in the domain of providing relevant and useful information on the real economic value of equity investments, this method also exhibits certain shortcomings in practice, which will be briefly highlighted here. The first of them refers to the *absence of clear and* *firm criteria for determining the existence of investor's significant influence*, as a major prerequisite for the application of the equity method. Although in accounting regulations an attempt has been made to correct this deficiency by offering a clear range of 20-50% of the voting rights, as a framework for demonstrating investor's significant influence, this financial criterion is only the starting point for determining the significant influence, whose existence is conditioned by the specific circumstances and characteristics of the particular investment. Thus, in practice, situations may arise where the investor who owns 50% of voting rights fails to exercise significant influence over the investee and does not have to apply the equity method. Oppositely, the second investor, who also owns 50% of voting rights, may exercise control on a contractual basis and, thus, become a parent company, which also precludes the application of the equity method. Finally, the third investor may make a significant influence with 50% of ownership interest in the investee (which is the most common case in practice) and therefore be obliged to use the equity method. So, hypothetically, three different investors, with identical ownership interest of 50%, may have three different levels of control over their investees and apply three different methods to account for their investments.

In the first part of this paper we have emphasized that the collection of evidence of the presence of significant influence should be based on the guidance, provided by the IAS 28 and FASB ASC 323, which opens the door for subjective judgment and, in some situations, manipulations in financial reporting. In this regard, many companies have developed the ways to control other entities, despite the fact that their equity participation is 50% and below. Such a way of acquiring control is supported by a variety of contractual arrangements, which limit one firm's ability to act without the approval of another, or which concern membership of the board of directors. Consequently, an entity may avoid consolidation of financial statements with explanation that control technically does not exist, because the participation is lower than 51% (Hoyle, 2010).

Another disadvantage of the equity method is the fact that *it allows and encourages off-balance sheet financing*, because its implementation does not entail full acquisition and consolidation of the assets, liabilities, revenues, expenses and capital of associates and joint ventures. Investors' financial statements only show the amount of the equity investment and the revenue it brings, while the value of that investment is affected only by changes in the net assets of the investee. The fact that investors, those using the equity method, do not show liabilities and assets of associates and joint ventures leads to a non-transparency and creates conditions for possible misuse of financial reporting. Above all, this can motivate companies to manipulate the concept of control and value certain investments using the equity method, rather than to carry out their full consolidation, because it will cover inefficient investments and all the risks involved. In support of this, let us just remember the negative example of company Enron regarding to hiding enormous amounts of investee's debts in its consolidated financial statements.

Non-disclosure of assets and liabilities of investees, those resulting from the application of the equity method, raises a justifiable question whether the investor should be responsible only for the acquired portion of net assets or should his responsibility also refer to all assets and liabilities of investees. Users of investors' financial statements are thus abridged for valuable information that would allow them to more realistically view the risks associated with investing in such entities. The best example of this lack of equity method is the practice of the company Coca-Cola, which in one period structured many of its investments in companies at just below a 50% of ownership level, following the strict rule that if ownership is 50% or less, control technically does not exist, that is consolidation should be based only on financial control. It allowed Coca-Cola to legally avoid consolidation of these entities, despite the fact that it had control over majority of them (Hsu et al., 2015). Also, avoiding the involvement of some entities in the consolidation cycle and the consequent application of the equity method allows companies to eliminate unrealized gains (resulting from intercompany transactions) only in proportion to the ownership interest, while in the case of consolidation, they would be eliminated completely. This suggests that the equity method encourages an increase in the volume of intercompany transactions that are followed by unrealistically high profits, behind which (especially in the case of multinational companies) can be the pursuit of tax savings and manipulation.[2]

Therefore, not including the investee's assets and liabilities in the financial statements of investors opens the possibility of off-balance sheet financing, which is followed by the presentation of a lower level of indebtedness, higher rates of return for assets and sales and higher earnings per share. Hence, the application of the equity method requires additional information about assets, liabilities, revenues, expenses and income of associates and joint ventures to be presented in notes of financial statements. An adequate providing of this additional information (that missing in the main body of financial statements), in some respects may be even an advantage of the equity method, because that kind of information cannot be identified separately in the case of consolidation. This should allow users of financial statements to obtain all relevant information and recognize all financial risks associated with off-balance sheet financing. But, regardless of the level and quality of these additional disclosures, in practice managers are generally motivated to apply the equity method, because the realization of various contractual arrangements, such as managerial compensations, is based primarily on the ratio indicators from the official financial statements (Hoyle, 2010).

The last important weakness of the equity method is its *negative impact on investor's cash flows and liquidity*, because the revenues from the investment are only partially accompanied by the cash inflows from dividends. Therefore, the investor's cash inflows will be lower than his revenues exactly for the portion of the investee's profit that has been retained and not distributed through dividends. In addition, higher revenue from investment, recognized in the amount of the part of investee's profit that is commensurate with equity participation, and not in the amount of the dividend paid (as with the acquisition method), increasing investor's profit, as a basis for taxation and distribution, which additionally threatens its liquidity (Škarić-Jovanović, 2014).

[2] It should be noted that the risks associated with covering up unsuccessful investments and poor financial performances in the consolidated financial statements are reduced by broadening and more comprehensively defining the control concept in accounting regulation (as it is done under IFRS 10, for example). This allows consolidation of entities in which investor's ownership interests is 50% or less, but over which there is an effective investor's control. At the same time, it creates barriers for firms which attempt to use a simple ownership rule to avoid consolidation.

CONCLUSION

Equity investments in other entities result in different levels of control of the investor over the investees. Accounting treatment of these investmens will primarily depend on whether on that occasion investor achieves absolute, significant, joint or common control. The equity method is used to account for investments in associates and joint ventures, over whose business the investor exercises significant influence or joint control. In determining whether there is a significant influence, as a primary criterion for applying the equity method, acquired voting rights in the range of 20-50% represent only a starting point. It needs to be supplemented by an analysis of other criteria, whose fulfillment proves that the investor exerts a significant influence over the investee. The lack of clarity of these criteria in practice often opens the door for subjective judgement and abuses in financial reporting. It is most often caused by management's intention to demonstrate more successful company performances and carried out by manipulating the concept of control and avoiding consolidation of subsidiaries.

The application of the equity method results in a different accounting treatment of certain business transactions with respect to their treatment when the acquisition method is applied under the consolidation of subsidiaries. Examples of these differences, that significantly affect the investor's financial performance, are different treatment of: impairment of goodwill, distribution of dividends, costs of acquisition, elimination of intercompany profits and losses etc. After the analysis of the information scopes of the equity method, we can conclude that it allows a close relationship between the value of equity investment and the net assets of investee, which results in providing of relevant information about the real economic value of the investor's assets. It is likely that these informational qualities of the equity method have led to a significant expansion of its scope in recent years, primarily within the separate financial statements and valuation of joint venture investments.

However, the application of the equity method in practice also manifests certain serious shortcomings, which are often emphasized by representatives of the academic and professional public. Namely, non-inclusion of investee's assets and liabilities in the investor's financial statements opens the possibility of off-balance sheet financing and presentation of a lower level of indebtedness. Consequently, the users of the financial statements are deprived of information that could allow them to more realistically consider all the risks associated with investing in a particular entity. Also, the application of the equity method has a negative effect on investor's cash flows, since the revenue from investment is only partially accompanied by the cash inflows from dividends received.

REFERENCES

Ašenbrenová, P. (2016). Disclosure of Joint Ventures and Associates in Financial Statement under IFRS. *European Financial and Accounting Journal, 11*(3), 85-94.

Demerens, F., Le Manh, A., Delvaille, P., & Pare, J. L. (2014). An ex ante analysis of change in reporting methods: the example of Joint Ventures. *Gestion 2000*, *31*(4), 65-89. doi:10.3917/g2000.314.0065

EFRAG. (2014). *Comment Letter - Equity Method in Separate Financial Statements ED/2013/10,* Retrieved from: https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FProject%20Documents%2F301%2FEFRAG%20Comment%20Letter%20-20Equity%20Method%20in%20Separate%20Financial%20Statements%20ED%202013%2010.pdf, Accessed on: 11 November 2019.

EFRAG. (2014a). *Final Endorsement Advice on IAS 27 - Equity Method in Separate Financial Statements.* Retrieved from: https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FLists%2_FProject%20News%2FAttachments%2F215%2FAmendments_to_IAS_27_EFRAG__Letter_to_the_EC.pdf, Accessed on: 13 November 2019.

Hoyle, J.B., Schaefer, T. F, & Doupnik, T. S. (2011). *Advanced Accounting*. 10th edition, New York: McGraw-Hill/Irwin

Hsu, A. W., Boochun, J., & Pourjalali, H. (2015). Does International Accounting Standard No. 27 Improve Investment Efficiency?. *Journal of Accounting, Auditing & Finance*, *30*(4), 484- 508.

IASB. (2013). *Exposure Draft: Equity Method in Separate Financial Statements,* ED/2013/10. London: IFRS Foundation.

IASB. (2011). *IAS 27 – Separate financial statements*. London: IFRS Foundation

IASB. (2011). *IAS 28 – Investments in associates and joint arrangements*. London: IFRS Foundation

IASB. (2011). *IFRS 11 – Joint arrangements.* London: IFRS Foundation

Leitner-Hanetseder, S., & Stockinger, M. (2014). How does the elimination of the proportionate consolidation method for joint venture investments influence European companies? *ACRN Journal of Finance and Risk Perspectives, 3*(1), 1-18.

So, S., Wang, K. S., Zhang, F., & Zhang, X. (2018). Value relevance of proportionate consolidation versus the equity method: Evidence from Hong Kong. *China Journal of AccountingResearch, 11*(4), 255-278. https://doi.org/10.1016/j.cjar.2018.06.002

Škarić-Jovanović. K. (2014). Uticaj primene metode udela na performanse investitora [Impact of the equity method's application on investor's performances]. *Acta economica*, *XII/20*, 59-75.

Škarić-Jovanović. K. (2015). Zajednički aranžmani – računovodstveni i izveštajni aspect [Joint arrangements – accounting and reporting aspect]. *Finrar*, *07/15*, 4-15.

INFORMACIONI DOMETI I DELOKRUG PRIMENE METODE UDELA

Ulaganja u kapital drugih preduzeća mogu da rezultiraju različitim intenzitetom kontrole nad njihovim poslovanjem i različitim proizilazećim odnosima između investitora i entiteta u koji je investirano. Za potrebe vrednovanja učešća u kapitalu pridruženih preduzeća i zajedničkih poduhvata, koja su praćena značajnim uticajem ili zajedničkom kontrolom investitora, koristi se metoda udela. Njenu primenu prati niz specifičnosti, koje rezultiraju potpuno drugačijim računovodstvenim tretmanom određenih poslovnih transakcija u odnosu na njihov tretman kada se primenjuje metoda sticanja i vrši puno konsolidovanje zavisnih entiteta. Cilj ovog rada se sastoji u analizi ključnih karakteristika i područja primene metode udela, što će biti praćeno posebnim osvrtom na neke od njenih najuočljivijih prednosti i nedostataka.

Ključne reči: *značajan uticaj, zajednička kontrola, metoda udela, konsolidovani finansijski izveštaji, separatni finansijski izveštaji.*