1972

Long-term investments (Supersedes statement on auditing procedure no. 34); Statement on auditing procedure, No. 51

American Institute of Accountants. Committee on Auditing Procedure

STATEMENT ON AUDITING PROCEDURE 51

Long-Term Investments

(Supersedes Statement on Auditing Procedure No. 34)

1. The purpose of this Statement is to furnish guidance in applying generally accepted auditing standards to examinations of the financial statements of companies with long-term investments accounted for under either the cost method or the equity method. Such investments may be represented by capital stock or other equity interests, bonds and similar debt obligations, and loans and advances that are in the nature of investments. This statement is concerned mainly with evidential matter which should be examined by the auditor in corroboration of (a) amounts at which long-term investments are stated in financial statements of the investor, (b) amounts reported as the investor's share of earnings or losses and other transactions of the investee, and (c) related disclosures.

Objectives of Examination

2. The independent auditor should ascertain whether long-term investments are accounted for in conformity with generally accepted accounting principles consistently applied, and whether

Issued by the Committee on Auditing Procedure
American Institute of Certified Public Accountants

the related disclosures are adequate. He should, therefore, examine sufficient competent evidential matter supporting the existence, ownership, cost, and carrying amount of investments, income and losses attributable to such investments, and any related disclosures in the investor's financial statements. With respect to investments accounted for under the equity method, he should also examine such evidential matter regarding the investor's accounting for its share of capital and other transactions of the investee.

3. With respect to the carrying amount of investments, a loss in value which is other than a temporary decline should be recognized in the financial statements of an investor. The independent auditor should, therefore, also examine sufficient competent evidential matter to the extent he deems necessary to determine whether such a loss in value has occurred.

Types of Evidence

4. Evidential matter pertaining to the existence, ownership, and cost of long-term investments includes accounting records and documents of the investor relating to their acquisition. In the case of investments in the form of securities (such as stocks, bonds, and notes), this evidential matter should be corroborated by inspection of the securities, or in appropriate circumstances, by written confirmation from an independent custodian of securities on deposit, pledged, or in safekeeping. In the case of loans, advances, and registered bonds and similar debt obligations, evidential matter obtained from accounting records and documents also should be corroborated by written confirmation from the debtor or trustee.

5. Evidential matter pertaining to the carrying amount of long-term investments, income and losses attributable to such investments, and capital and other transactions of the investee may be available in the following forms:

a. Audited Financial Statements

(i) Financial statements of the investee generally constitute sufficient evidential matter as to the equity in underlying net assets and results of operations of the investee when such statements have been examined by the investor's auditor or by another independent auditor whose report is satisfactory, for this purpose, to the investor's auditor. Audited financial statements also constitute one of the items of evidential matter that may be used with respect to investments in bonds and similar debt obligations, loans, and advances.

(ii) With respect to investments accounted for under the equity method, the auditor who uses another auditor's report for the purpose of reporting on the investor's equity in underlying net assets and its share of earnings or losses and other transactions of the investee is in the position of a principal auditor using the work and reports of other auditors. Under these circumstances, the auditor may decide that it would be appropriate to refer to the other auditor's examination in his report on the financial statements of the investor. (See paragraphs 6 through 11 of Statement on Auditing Procedure No. 45.[1]) When the work and reports of other auditors constitute a major element of evidence with respect to investments accounted for under the cost method, the auditor may be in a position analogous to that of a principal auditor.

b. Unaudited Financial Statements

(i) Unaudited financial statements, reports issued on examination by regulatory bodies and taxing authorities, and similar data provide information and evi-

[1] Neither this subparagraph nor Statement on Auditing Procedure No. 45 should be construed to require or imply that an auditor in deciding whether he may properly serve as principal auditor, without himself auditing particular subsidiaries, divisions, branches, components or investments of his client, should make that decision on any basis other than his judgment regarding the professional considerations as discussed in paragraphs 2 and 10 of Statement on Auditing Procedure No. 45. In addition, it should be understood that an auditor's report which makes reference to the report of another auditor is not to be construed as a qualified report, nor as being inferior in professional standing to a report in which no such reference is made.

dence, but are not by themselves sufficient as evidential matter.

(ii) By application of auditing procedures to the financial statements of an investee, the auditor obtains evidential matter as to the equity in underlying net assets and results of operations of the investee. The auditor for the investor may utilize the investee's auditor for this purpose. The materiality of the investment in relation to the financial statements of the investor is a factor which should be considered in determining the extent and nature of such procedures.

c. Market Quotations

If market quotations of security prices are based on a reasonably broad and active market, they ordinarily constitute sufficient competent evidential matter as to the current market value of unrestricted securities.

d. Other Evidential Matter

(i) When the carrying amount of an investment reflects (a) factors (such as mineral rights, growing timber, patents, and goodwill) which are not recognized in financial statements of the investee, or (b) fair values of assets which are materially different from the investee's carrying amounts, evidential matter may be available in the form of current evaluations of these factors. Evaluations made by persons within the investor or within the investee may be acceptable; evaluations made by persons independent of these companies will usually provide greater assurance of reliability than evaluations made by persons within the companies.

(ii) Negotiable securities, real estate, chattels, or other property are often assigned as collateral for investments in bonds, notes, loans, or advances. If the collateral is an important factor in considering collectibility of the obligation, the auditor should satisfy himself regarding the existence and transferability of such collateral, and should obtain evidential matter as to its value (such as market quotations, the amount of underlying net assets, or appraisals) as may be appropriate in the circumstances.

Equity Method of Accounting

6. Paragraph 17 of Accounting Principles Board Opinion No. 18 states that the equity method of accounting for an investment in common stock should be used by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. It also provides several criteria to be considered in determining whether the investor has the ability to exercise significant influence. Paragraph 16 of Opinion No. 18 also states that the equity method should be followed for investments in common stock of corporate joint ventures.

7. The auditor has a responsibility to satisfy himself with respect to the appropriateness of the accounting method adopted for investments in voting stock of an investee. Inquiry should be made of the investor's management as to (a) whether the investor has the ability to exercise significant influence over operating and financial policies of the investee under the criteria set forth in paragraph 17 of Opinion No. 18 and (b) the attendant circumstances which serve as a basis for management's conclusion. The auditor should evaluate the information received on the basis of facts otherwise obtained by him in the course of his audit.

8. When an investor accounts for an investment in an investee contrary to the applicable presumption contained in Paragraph 17 of Opinion No. 18,[2] the auditor should examine sufficient com-

[2] Paragraph 17 states: ". . . an investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such an ability can be demonstrated."

petent evidential matter to satisfy himself that such presumption has been overcome and that appropriate disclosure is made regarding the reasons for not accounting for the investment in keeping with the presumption.[3]

9. The refusal of an investee to furnish necessary financial data to the investor is evidence (but not necessarily conclusive evidence) that the investor does not have the ability to exercise significant influence over operating and financial policies of the investee such as to justify the application of the equity method of accounting for investments in 50% or less owned companies in accordance with the provisions of Opinion No. 18.

10. An investor should include its proportionate share of an investee's results of operations based on data obtained from the investee's most recent reliable financial statements, which may be its audited year-end statements.

11. An investor may include its proportionate share of the results of operations of an investee based on the investee's unaudited interim financial statements. An example of this would be a situation in which an investor whose year ends on June 30 includes its equity in earnings of an investee based on the investee's financial statements for the six-month period ended December 31 and the six-month period ended June 30. In such situations, the auditor for the investor should recognize that although the investee's financial statements for the year ended December 31 may have been audited, the financial statements as of June 30 and for the year then ended represent unaudited data because neither six-month period is covered by an auditor's report. Auditing procedures (see paragraph 5(b)(ii) of this Statement) should be applied to such unaudited financial statements to the extent considered necessary in view of their materiality in relation to the financial statements of the investor.

12. In many instances there will be a time lag in reporting between the dates of the financial statements of the investor and those of the investee. A time lag in reporting should be consistent from period to period. If a change in time lag occurs which the

[3] See Accounting Principles Board Opinion No. 18, paragraph 20, footnote 13.

auditor deems to have a material effect on the investor's financial statements, he should express in his opinion an exception as to consistency.

13. With respect to events and transactions of the investee from the date of the investee's financial statements to the date of the report of the auditor of the investor, the auditor should read available interim financial statements of the investee and make appropriate inquiries of the investor. Further, the auditor should ascertain through such inquiries that the investor has made itself aware of any material events or transactions arising subsequent to the date of the investee's financial statements. Such events or transactions of the type contemplated by paragraphs 5 and 6 of Statement on Auditing Procedure No. 47, which are material in relation to the financial statements of the investor, should be disclosed in the notes to the investor's financial statements and (where applicable) labeled as unaudited information. For the purpose of recording the investor's share of the results of operations of the investee, recognition should be given to events or transactions of the type contemplated by paragraph 3 of Statement on Auditing Procedure No. 47, which are material in relation to the financial statements of the investor.

14. In certain circumstances, events or transactions during the period between the date of the investee's financial statements and the date of the investor's financial statements may be of such a nature and significance as to cause a loss in value of the investment which should be recognized in the investor's financial statements (see paragraph 19(h) of Opinion No. 18).

15. For investments accounted for under the equity method, data relating to transactions between the investor and investee should be obtained for purposes of determining the proper elimination of unrealized intercompany profits and losses. Normally, such data are not shown separately in the financial statements of the investee and may have to be obtained from the investee. If the amounts of unrealized intercompany profits or losses could reasonably be expected to be material in relation to the investor's financial position or results of operations, unaudited data obtained from the investee ordinarily should be subjected to auditing procedures (see paragraph 5(b)(ii) of this Statement).

Effects on Auditor's Report

16. When the effects of accounting for long-term investments are material in relation to financial position or results of operations of the investor, the independent auditor is not in a position to express an unqualified opinion on the investor's financial statements unless he has obtained sufficient competent evidential matter in support of the objectives described in paragraph 2. There may be situations where there is an effective limitation on the scope of the auditor's examination because sufficient evidential matter is not available to him. Examples of such scope limitations, generally with respect to investments accounted for under the equity method, would be: (a) the auditor not being able to obtain audited financial statements of an investee or to apply auditing procedures to unaudited financial statements of an investee and (b) the auditor not being able to examine sufficient evidential matter relating to the elimination of unrealized profits and losses resulting from transactions between the investor and the investee. In such situations, the auditor should indicate in the scope paragraph of his report the limitations on his work and, depending on materiality of the amounts involved, he should either qualify his opinion or disclaim an opinion.

17. There may be situations in which the auditor has examined available evidential matter but finds that because of existing conditions there is substantial uncertainty as to whether there has occurred a loss in value which is other than a temporary decline. In such circumstances the independent auditor should either qualify his opinion or disclaim an opinion on the financial statements taken as a whole, depending on the materiality of the investment.

The Statement entitled "Long-Term Investments" was adopted by the assenting votes of twenty-one members of the Committee of whom Messrs. Chapin, Chazen, Fitzgerald, and Johnson assented with qualifications.

Messrs. Chapin, Chazen, Fitzgerald and Johnson qualify their assent to the issuance of this Statement with respect to paragraph 10. They are concerned with the implication of the reference to a reliability criterion in conjunction with the phrase "which may be its audited year-end statements." They believe the effect will be to encourage some investors to use audited year-end data of their investees in preference to more recent reliable data of the investees which may be available. To the extent that application of paragraph 10 delays reflecting the results of operations of an investee in the financial statements of an investor, the reliability of the financial statements may be adversely affected. In such event, it may be necessary for the investor to disclose in the financial statements the subsequent interim earnings or losses of the investee. Generally, such disclosure is clearly less desirable than using the more current investee financial data in the first instance. In addition, Mr. Fitzgerald believes that when there are material investments accounted for under the equity method, the lag period between the dates of the investor and investee statements should be limited to not more than three months, as is current practice for consolidation of subsidiary companies.

NOTE

Statements on Auditing Procedure present the considered opinion of the Committee on Auditing Procedure, which is the senior technical committee of the Institute designated to issue pronouncements on auditing matters. Departures from the Committee's recommendations must be justified by those who do not follow them.