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# Reporting on consistency and accounting changes (supersedes chapter 8 of statement on auditing procedure no. 33); Statement on auditing procedure, No. 53

American Institute of Accountants. Committee on Auditing Procedure

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# STATEMENT ON 'AUDITING PROCEDURE 53

# *Reporting on Consistency and Accounting Changes*

(Supersedes Chapter 8 of Statement on Auditing Procedure No. 33)

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

## INTRODUCTION

1. Accounting Principles Board Opinion No. 20, "Accounting Changes," defines various types of accounting changes and establishes guides for determining the manner of accounting for the effect of each type of change. Some of these changes involve the second standard of reporting which is part of generally accepted auditing standards. This Statement identifies accounting changes that involve the second standard of reporting and provides guidance to the independent auditor for applying this standard and for reporting when accounting changes have occurred. (This Statement, which modifies prior practice, is not intended to be retroactive.)

## CONSISTENCY STANDARD

2. The second standard of reporting (referred to herein as the consistency standard) is, "The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period."

3. The objective of the consistency standard is (a) to give assurance that the comparability of financial statements between periods has not been materially affected by changes in accounting principles, which include not only accounting principles and practices but also the methods of applying them, or (b) if comparability has been materially affected by such changes, to require appropriate reporting by the independent auditor regarding such changes. It is implicit in the objective that such principles have been consistently observed within each period.

4. Proper application of the consistency standard by the independent auditor requires an understanding of the relationship of consistency to comparability. Although lack of consistency may cause lack of comparability, other factors unrelated to consistency may also cause lack of comparability.[1]

[1] For a discussion of comparability of financial statements of a single enterprise, see paragraphs 95 through 97 of Accounting Principles Board Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises."

5. A comparison of the financial statements of an entity between years may be affected by (a) accounting changes, (b) an error in previously issued financial statements, (c) changes in classification, and (d) events or transactions substantially different from those accounted for in previously issued statements. Accounting change, as defined in APB Opinion No. 20, means a change in (1) an accounting principle, (2) an accounting estimate, or (3) the reporting entity (which is a special type of change in accounting principle).

6. Changes in accounting principle having a material effect on the financial statements require recognition in the independent auditor's opinion as to consistency. Other factors affecting comparability in financial statements may require disclosure, but they would not ordinarily be commented upon in the independent auditor's report.

## Accounting Changes Affecting Consistency

### *Change in accounting principle*

7. "A change in accounting principle results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes. The term *accounting principle* includes not only accounting principles and practices but also the methods of applying them."[2] A change in accounting principle includes, for example, a change from the straight-line method to the declining balance method of depreciation for all assets in a class or for all newly acquired assets in a class, and a change from expensing research and development costs to amortizing such costs over the estimated period benefited. The consistency standard is applicable to this type of change and requires recognition in the auditor's opinion as to consistency.

### *Change in the reporting entity*

8. Since a change in the reporting entity is a special type of change in accounting principle, the consistency standard is applicable. Changes in reporting entity that require recognition in the auditor's opinion include the following:

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[2] Accounting Principles Board Opinion No. 20, paragraph 7.

a. Presenting consolidated or combined statements in place of statements of individual companies.

b. Changing specific subsidiaries comprising the group of companies for which consolidated statements are presented.

c. Changing the companies included in combined financial statements.

d. Changing among the cost, equity and consolidation methods of accounting for subsidiaries or other investments in common stock.

9. A business combination accounted for by the pooling-of-interests method also results in a change in reporting entity. The application of the consistency standard to this type of change is discussed in Statement on Auditing Procedure No. 44.

10. For purposes of application of the consistency standard, a change in reporting entity does not result from the creation, cessation, purchase, or disposition of a subsidiary or other business unit.

#### *Correction of an error in principle*

11. A change from an accounting principle that is not generally accepted to one that is generally accepted, including correction of a mistake in the application of a principle, is a correction of an error. Although this type of change in accounting principle should be accounted for as the correction of an error,[3] the change requires recognition in the auditor's opinion as to consistency.[4]

#### *Change in principle inseparable from change in estimate*

12. The effect of a change in accounting principle may be inseparable from the effect of a change in estimate.[5] Although the accounting for such a change is the same as that accorded a change only in estimate, a change in principle is involved.

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[3] See paragraphs 13, 36, and 37 of Accounting Principles Board Opinion No. 20.

[4] The appropriate form of reporting on consistency in such circumstances is similar to that illustrated in paragraph 25 of this Statement.

[5] See paragraph 11 of Accounting Principles Board Opinion No. 20.

Accordingly, this type of change requires recognition in the independent auditor's opinion as to consistency.

## Changes Not Affecting Consistency

### *Change in accounting estimate*

13. Accounting estimates (such as service lives and salvage values of depreciable assets and provisions for warranty costs, uncollectible receivables, and inventory obsolescence) are necessary in the preparation of financial statements. Accounting estimates change as new events occur and as additional experience and information is acquired. This type of accounting change is required by altered conditions that affect comparability, but do not involve the consistency standard. The independent auditor, in addition to satisfying himself with respect to the conditions giving rise to the change in accounting estimate, should satisfy himself that the change does not include the effect of a change in accounting principle. Provided he is so satisfied, he need not comment on the change in his report because it does not affect his opinion as to consistency.[6] However, an accounting change of this type having a material effect on the financial statements may require disclosure in a note to the financial statements.[7]

### *Error correction not involving principle*

14. Correction of an error in previously issued financial statements resulting from mathematical mistakes, oversight, or misuse of facts that existed at the time the financial statements were originally prepared does not involve the consistency standard if no element of accounting principles or their application is included. Accordingly, the independent auditor need not recognize the correction in his opinion as to consistency.[8]

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[6] With respect to financial statements filed with the Securities and Exchange Commission, Regulation S-X requires the independent auditor to express an opinion as to any change in accounting principle or practice that materially affects *comparability*. These requirements may be met by the use of a middle paragraph in the auditor's report in which he describes the change and expresses his view thereon; when this is done, there should not be a reference to the change in the opinion paragraph if the consistency standard is not involved.

[7] See paragraph 33 of Accounting Principles Board Opinion No. 20.

[8] If the independent auditor had previously reported on the financial statements containing the error, he should refer to Statement on Auditing Procedure No. 41, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report."

### *Changes in classification and reclassifications*

15. Classifications in the current financial statements may be different from classifications in the prior year's financial statements. Although changes in classification are usually not of sufficient importance to necessitate disclosure, material changes in classification should be indicated and explained in the financial statements or notes. These changes and material reclassifications made in previously issued financial statements to enhance comparability with current financial statements ordinarily would not affect the independent auditor's opinion as to consistency and need not be referred to in his report.

### *Substantially different transactions or events*

16. Accounting principles are adopted when events or transactions first become material in their effect. Such adoption, as well as modification or adoption of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring, do not involve the consistency standard, although disclosure in the notes to the financial statements may be required.

### *Changes expected to have a material future effect*

17. If an accounting change has no material effect on the financial statements in the current year, but the change is reasonably certain to have substantial effect in later years, the change should be disclosed in the notes to the financial statements whenever the statements of the period of change are presented, but the independent auditor need not recognize the change in his opinion as to consistency.

### *Disclosure of changes not affecting consistency*

18. While the matters discussed in paragraphs 13 through 17 do not require recognition in the independent auditor's report as to consistency, the auditor should qualify his report as to the disclosure matter if necessary disclosures are not made.

### Periods to Which the Consistency Standard Relates

19. When the independent auditor reports only on the current period, he should report on the consistency of the application of accounting principles in relation to the preceding period, regardless of whether financial statements for the preceding period are presented. (The term "current period" means the most recent year, or period of less than one year, upon which the independent auditor is reporting.) When the independent auditor reports on two or more years, he should report on the consistency of the application of accounting principles between such years and also on the consistency of such years with the year prior thereto if such prior year is presented with the financial statements being reported upon.

## REPORTING ON CONSISTENCY

### Consistency Expression

20. When the independent auditor is expressing an opinion on the financial statements of a single year, the phrase "on a basis consistent with that of the preceding year" is appropriate; however, if the financial statements are for the initial accounting period of a company, he should not refer to consistency because no previous period exists with which to make a comparison. If the auditor's report covers two or more years, language similar to "applied on a consistent basis" should be used. In such cases, if the year preceding the earliest year being reported upon is also presented, language similar to "consistently applied during the period and on a basis consistent with that of the preceding year" should be used.

### First Examinations

21. When the independent auditor has not examined the financial statements of a company for the preceding year, he should adopt procedures that are practicable and reasonable in the circumstances to assure himself that the accounting principles employed are consistent between the current and the preceding year. Where adequate records have been maintained by the client, it is usually practicable and reasonable to extend

auditing procedures sufficiently to give an opinion as to consistency.

22. Inadequate financial records or limitations imposed by the client may preclude the independent auditor from forming an opinion as to the consistent application of accounting principles between the current and the prior year, as well as to the amounts of assets or liabilities at the beginning of the current year. Where such amounts could materially affect current operating results, the independent auditor would also be unable to express an opinion on the current year's results of operations and changes in financial position. Following is an example of reporting where the records are inadequate:

(Scope paragraph)

. . . and such other auditing procedures as we considered necessary in the circumstances, except as indicated in the following paragraph.

(Middle paragraph)

Because of major inadequacies in the company's accounting records for the previous year, it was not practicable to extend our auditing procedures to enable us to express an opinion on results of operations and changes in financial position for the year ended (current year) or on the consistency of application of accounting principles with the preceding year.

(Opinion paragraph)

In our opinion, the accompanying balance sheet presents fairly the financial position of X Company as of (current year end) in conformity with generally accepted accounting principles.

23. If accounting records for prior years were kept on a basis which did not result in a fair presentation of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles for those years, and it is impracticable to restate financial statements for those years,[9] the independent auditor should omit the customary

[9] If restatement of prior years' statements is practicable, paragraph 11 of this Statement is applicable.

reference to consistency and present his report similar to the following:

(Middle paragraph)

The company has kept its records and has prepared its financial statements for previous years on the cash basis with no recognition having been accorded accounts receivable, accounts payable, or accrued expenses. At the beginning of the current year the company adopted the accrual basis of accounting. Although appropriate adjustments have been made to retained earnings as of the beginning of the year, it was not practicable to determine what adjustments would be necessary in the financial statements of the preceding year to restate results of operations and changes in financial position in conformity with the accounting principles used in the current year.

(Opinion paragraph)

In our opinion, the aforementioned financial statements present fairly the financial position of X Company as of October 31, 19—, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles.

### Change in Accounting Principle

24. When there is a change in accounting principle, the independent auditor should modify his opinion as to consistency, indicating the nature of the change. The auditor's concurrence with a change is implicit unless he takes exception to the change in expressing his opinion as to fair presentation of the financial statements in conformity with generally accepted accounting principles. Nevertheless, in order to be more informative the auditor should make his concurrence explicit (unless the change is the correction of an error) using the expression "with which we concur." The form of modification of the opinion depends on the method of accounting for the effect of the change, as explained in paragraphs 25 and 26.[10]

[10] With respect to the method of accounting for the effect of a change in accounting principle, see Accounting Principles Board Opinion No. 20, including paragraph 4 which states that methods of accounting for changes in principles have been and will be specified in pronouncements other than Opinion No. 20.

25. If there has been a change in accounting principle which should be reported by restating the financial statements of prior years,[11] the appropriate reference to consistency is that the statements are consistent after giving retroactive effect to the change. Illustrations of appropriate reporting follow:

(Opinion paragraph covering one year)

. . . applied on a basis consistent with that of the preceding year after giving retroactive effect to the change, with which we concur, in the method of accounting for long-term construction contracts as described in Note X to the financial statements.

(Opinion paragraph covering two years)

. . . applied on a consistent basis after restatement for the change, with which we concur, in the method of accounting for long-term construction contracts as described in Note X to the financial statements.

The auditor's report need not refer to a change in accounting principle and restatement made in conformity with generally accepted accounting principles if the statements for the year of change are reported upon together with the financial statements for a year subsequent to the year of change.

26. If there has been a change in accounting principle which should be reported by means other than by restating the financial statements of prior years and the independent auditor is reporting only on the year during which the change was made, his report should state that accounting principles have been consistently applied except for the change. An example of such reporting follows:

(Opinion paragraph)

. . . in conformity with generally accepted accounting principles which, except for the change (with which we concur) in the method of computing depreciation as described in Note X to the financial statements, have been applied on a basis consistent with that of the preceding year.

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[11] With respect to reporting on financial statements after a pooling of interests, see Statement on Auditing Procedure No. 44, "Reports Following a Pooling of Interests" and paragraphs 15 and 16 of Statement on Auditing Procedure No. 45, "Using the Work and Reports of Other Auditors."

If the independent auditor is reporting on two or more years when reporting on a subsequent year's financial statements, he should make appropriate reference to the change as long as the year of change is included in the years being reported upon. If the year of change was other than the earliest year being reported upon, the following example would be an appropriate form of reporting:

(Opinion paragraph)

> . . . in conformity with generally accepted accounting principles consistently applied during the period except for the change, with which we concur, in the method of computing depreciation as described in Note X to the financial statements.

If the year of change is the earliest year being reported upon, there is no inconsistency in the application of accounting principles during the period subsequent to the change, but the auditor should make reference to the change having been made in such year. Following is an example of appropriate reporting:

(Opinion paragraph)

> . . . in conformity with generally accepted accounting principles consistently applied during the period subsequent to the change, with which we concur, made as of January 1, 19—, in the method of computing depreciation as described in Note X to the financial statements.

A change in accounting principle made at the beginning of the year preceding the earliest year being reported upon by the auditor does not result in an inconsistency between such preceding year and later years. In reporting on consistency of a later year with such preceding year, reference to a change is not necessary.

## REPORTING ON CHANGES IN ACCOUNTING PRINCIPLE THAT ARE NOT IN CONFORMITY WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

27. The auditor should evaluate a change in accounting principle to satisfy himself that (a) the newly adopted accounting

principle is a generally accepted accounting principle, (b) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, and (c) management's justification[12] for the change is reasonable. If a change in accounting principle does not meet these conditions, the auditor's report should so indicate and his opinion should be appropriately qualified as discussed in paragraphs 28 through 34.

## Reporting in the Year of Change

28. If a newly adopted accounting principle is not a generally accepted accounting principle or the method of accounting for the effect of the change is not in conformity with generally accepted accounting principles, the auditor should express a qualified opinion, or if the effect of the change is sufficiently material, the auditor should express an adverse opinion on the financial statements taken as a whole due to a lack of conformity with generally accepted accounting principles. If a qualified opinion is expressed, the qualification would relate both to conformity with generally accepted accounting principles and to the consistency of application. When expressing an adverse opinion in such circumstances, no reference to consistency need be made because the financial statements are not presented in conformity with generally accepted accounting principles.[13] Following is an illustration of reporting where the newly adopted accounting principle is not a generally accepted accounting principle:

(Middle paragraph)

> The company previously recorded its land at cost but adjusted the amounts to appraised values during the year, with a corresponding increase in stockholders' equity in the amount of $XXX.

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[12] Accounting Principles Board Opinion No. 20, paragraph 16, states: "The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable." The requirement for justification is applicable to years beginning after July 31, 1971.

[13] Footnote disclosure of an inconsistency in accounting principles unrelated to the reason for an adverse opinion is required even though the independent auditor does not refer to the inconsistency in his report. If such an inconsistency is not disclosed, the independent auditor should also qualify his report for this lack of disclosure.

In our opinion, the new basis on which land is recorded is not in conformity with generally accepted accounting principles.

(Opinion paragraph)

In our opinion, except for the change to recording appraised values as described above, the aforementioned financial statements present fairly the financial position of X Company at December 31, 19—, and the results of its operations and changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

29. If management has not provided reasonable justification for a change in accounting principles, the independent auditor should express an exception to the change having been made without reasonable justification. Such qualification would relate both to conformity with generally accepted accounting principles and to the consistency of application. An example follows:

(Middle paragraph)

As disclosed in Note X to the financial statements, the company has adopted (description of newly adopted method), whereas it previously used (description of previous method). Although use of the (description of newly adopted method) is in conformity with generally accepted accounting principles, in our opinion, the company has not provided reasonable justification for making a change as required by Opinion No. 20 of the Accounting Principles Board.

(Opinion paragraph)

In our opinion, except for the change in accounting principles as stated above, the aforementioned financial statements present fairly the financial position of X Company at December 31, 19—, and the results of its operations and changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

## Reporting in Subsequent Years

30. Whenever an accounting change results in an independ-

ent auditor expressing a qualified or adverse opinion on the conformity of financial statements with generally accepted accounting principles for the year of change, he should consider the possible effects of that change when reporting on the entity's financial statements for subsequent years, as discussed in paragraphs 31 through 34.

31. If the financial statements for the year of such change are presented with a subsequent year's financial statements, the auditor's report should disclose his reservations with respect to the statements for the year of change.

32. If an entity has adopted an accounting principle which is not a generally accepted accounting principle, its continued use may have a material effect on the statements of a subsequent year on which the auditor is reporting. In this situation, the independent auditor should express either a qualified or an adverse opinion, depending upon the materiality of the departure in relation to the statements of the subsequent year.

33. If an entity accounts for the effect of a change prospectively, when generally accepted accounting principles require restatement or the inclusion of the cumulative effect of the change in the year of change, a subsequent year's financial statements could improperly include a charge or credit which is material to those statements. This situation also requires that the auditor express a qualified or an adverse opinion.

34. If management has not provided reasonable justification for a change in accounting principles, the auditor's opinion should express an exception to the change having been made without reasonable justification, as previously indicated. In addition, the auditor should continue to express his exception with respect to the financial statements for the year of change as long as they are presented. However, the auditor's exception relates to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing an exception for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express an exception to use of the newly adopted principle.

## PRO FORMA EFFECTS OF ACCOUNTING CHANGES

35. In single-year financial statements, the pro forma effects of retroactive application of certain accounting changes should be disclosed.[14] In such situations, the reporting provisions of paragraph 48, Chapter 10, of Statement on Auditing Procedure No. 33 are applicable to the prior year data.

*The Statement entitled "Reporting on Consistency and Accounting Changes" was adopted by the assenting votes of twenty-one members of the Committee of whom Messrs. Burris, Fitzgerald, Gomprecht, Kist, Nest, Pivar, and Werner assented with qualifications.*

Messrs. Burris and Fitzgerald qualify their assent to the issuance of this Statement with respect to paragraphs 6 and 13 because they believe the provisions therein discourage informative disclosure by the independent auditor of certain accounting changes which significantly affect comparability of financial statements. These paragraphs provide that changes in accounting estimates, such as in the estimated service life or salvage value of depreciable assets, do not require recognition in the auditors' report, while changes in the depreciation method of such assets involve the consistency standard of reporting. Messrs. Burris and Fitzgerald believe that this distinction impairs the comparability objective of the second standard of reporting, as set forth in paragraph 3 of this Statement, and is one that will not be easily understood by many users of financial statements. They believe this Statement should require the auditor to comment, and indicate his position, on any significant changes in accounting estimates affecting the comparability of financal statements which require disclosure under generally accepted accounting principles.

Mr. Gomprecht assents to publication of this Statement, but dissents to paragraph 34 which permits the auditor to elect to issue an unqualified opinion in years subsequent to a year in which a change is made for which management has not pro-

[14] See paragraph 21 of Accounting Principles Board Opinion No. 20.

vided reasonable justification, without providing criteria by which that election may be made. He believes that failure to provide reasonable justification for a change to a "generally accepted accounting principle" may make that principle inapplicable in the circumstances and, thus, may result in misleading inferences being drawn from such financial statements. He believes that the independent auditor should be advised to consider carefully the decision not to express an exception in subsequent years to the use of the newly adopted principle.

Mr. Kist assents to the issuance of this Statement, but dissents to paragraph 17 because it permits the auditor not to observe the consistency standard even when he is reasonably certain that the change made in the current year will have a significant effect on financial position and results of operations in succeeding years. He believes that the only purpose for the auditor's reference to consistency, particularly since the publication of APB Opinion No. 20, is to direct the reader's attention to the change, which purpose is not achieved in the foregoing circumstances.

Messrs. Kist and Nest dissent to paragraph 26 because it requires the auditor to express an opinion that will be regarded as a qualified opinion (see paragraph 11, Chapter 10 of SAP 33) even though there is no change in the accounting principles applied during the periods presented and reported on.

Mr. Pivar qualifies his assent to the issuance of this Statement with respect to paragraphs 27 and 29. He believes that since those paragraphs require the auditor to evaluate the reasonableness of the justification of an accounting change, and possibly conclude on a qualification in his report, the Statement should provide some criteria to which the auditor could look in reaching his conclusion.

Mr. Werner assents to the issuance of this Statement but dissents to certain aspects of paragraphs 14, 19 and 24. With regard to paragraph 14, he does not agree with the implication in the last sentence of that paragraph that a correction of an error (other than a change from a principle which is not generally accepted) may affect the auditor's opinion as to consistency in some cases. As to paragraph 19, Mr. Werner does not agree with the last sentence which requires the auditor to report on the consistency of two or more years reported on with the immediately preceding year, if presented. He believes that (a) if two or more years are reported on, the auditor should comment on consistency in the opinion paragraph of his report only as to consistency among the years reported on and (b) if prior years are presented but not reported on and if the client does not supply adequate disclosure on accounting principles changes in the financial statements including related notes, the auditor should disclose any inconsistency of which he is aware among the years presented (including an inconsistency with the years reported on) by means of a middle paragraph.

Mr. Werner also does not agree with paragraph 24 which requires the auditor to express explicit concurrence with the client's change in accounting principle. He believes that, under APB Opinion No. 20, when the auditor reports that statements for the year of change conform to generally accepted accounting principles, he is properly reporting on the change in the context of the financial statements taken as a whole. Consequently, Mr. Werner believes it is not appropriate to single out one of the client's accounting principles for concurrence. For example, under this Statement auditors will be required to concur in changes that clients make to comply with a pronouncement of the Financial Accounting Standards Board. He also believes the language "in which we concur" may lead a reader of the report to conclude improperly that the auditor assumes more responsibility than the language of paragraph 27 of the Statement requires when it states that the auditor is responsible only for whether "management's justification for the change is reasonable".

## 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.*

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