AU Section 420

Consistency of Application of Generally Accepted Accounting Principles[*]

Source: SAS No. 1, section 420; SAS No. 43; SAS No. 88.

See section 9420 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 The second standard of reporting (referred to herein as the consistency standard) is:

> The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

[Revised, November 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 113.]

.02 The objective of the consistency standard is to ensure that if comparability of financial statements between periods has been materially affected by changes in accounting principles, there will be appropriate reporting by the independent auditor regarding such changes.[1] It is also implicit in the objective that such principles have been consistently observed within each period. The auditor's standard report implies that the auditor is satisfied that the comparability of financial statements between periods has not been materially affected by changes in accounting principles and that such principles have been consistently applied between or among periods because either (*a*) no change in accounting principles has occurred, or (*b*) there has been a change in accounting principles or in the method of their application, but the effect of the change on the comparability of the financial statements is not material. In these cases, the auditor would not refer to consistency in his report.

.03 Proper application of the consistency standard by the independent auditor requires an understanding of the relationship of consistency to

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[*] This section has not been updated to reflect the issuance of Financial Accounting Standards Board (FASB) Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*, which supersedes Accounting Principles Board Opinion No. 20, *Accounting Changes*. It is expected to be updated when this section is clarified in accordance with the AICPA Auditing Standards Board's (ASB) Clarity Project. The clarity project is a significant effort that the ASB has undertaken to make U.S. generally accepted auditing standards easier to read, understand, and apply by utilizing established clarity drafting conventions. Once finalized, the effective date of all clarified standards is expected to apply to audits of financial statements for periods beginning on or after December 15, 2010. This date is provisional, but will not be earlier.

In July 2009, FASB approved FASB *Accounting Standards Codification* (ASC), effectively superseding FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, because all of the FASB ASC content carries the same level of authority. FASB ASC is now the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). As of July 1, 2009, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC became nonauthoritative.

As a result of these developments, this section has not been conformed to reflect FASB ASC.

[1] The appropriate form of reporting on a lack of consistency is discussed in section 508, *Reports on Audited Financial Statements*, paragraphs .16–.18. [Footnote added to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53–62.]

comparability. Although lack of consistency may cause lack of comparability, other factors unrelated to consistency may also cause lack of comparability.[2]

.04 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 [AC section A06], 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).

.05 Changes in accounting principle having a material effect on the financial statements require recognition in the independent auditor's report through the addition of an explanatory paragraph (following the opinion paragraph). 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

.06 "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."[3] 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. The consistency standard is applicable to this type of change and requires recognition in the auditor's report through the addition of an explanatory paragraph. [As modified, effective January 1, 1975, by FASB Statement No. 2 (AC section R50).]

Change in the Reporting Entity

.07 A change in the reporting entity is a special type of change in accounting principle, which results in financial statements that, in effect, are those of a different reporting entity. This type is limited mainly to—

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.

A business combination accounted for by the pooling of interests method also results in a different reporting entity.[4] [As amended, effective December 1999, by Statement on Auditing Standards No. 88.]

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[2] For a discussion of comparability of financial statements of a single enterprise, see paragraphs 111 through 119 of FASB Statement of Financial Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information." [Footnote renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53–62. Revised, June, 1993, to reflect conforming changes necessary due to the issuance of Statement of Position 93-3.]

[3] Accounting Principles Board Opinion No. 20, paragraph 7 [AC section A06.105]. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53–62.]

[4] APB Opinion No. 20 paragraph .12. [Footnote added, effective December 1999, by Statement on Auditing Standards No. 88.]

.08 A change in the reporting entity resulting from a transaction or event, such as a pooling of interests, or the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit, does not require that an explanatory paragraph about consistency be included in the auditor's report. A change in the reporting entity that does not result from a transaction or event requires recognition in the auditor's report through inclusion of an explanatory paragraph. [Paragraph added, effective December 1999, by Statement on Auditing Standards No. 88.]

.09 When companies have merged or combined in a pooling of interests, appropriate effect of the pooling should be given in the presentation of financial position, results of operations, cash flows, and other historical financial data of the continuing business for the year in which the combination is consummated and, in comparative financial statements, for years prior to the year of pooling, as described in APB Opinion No. 16, *Business Combinations* [AC section B50]. If prior year financial statements, presented in comparison with current year financial statements, are not restated to give appropriate recognition to a pooling of interests, a departure from generally accepted accounting principles has occurred which necessitates that the auditor express a qualified or an adverse opinion as discussed in section 508, *Reports on Audited Financial Statements*, paragraphs .35–.40. Since the inconsistency arises not from a change in the application of an accounting principle in the current year, but from the lack of such application to prior years, an explanatory paragraph (in addition to the modification relating to the departure from generally accepted accounting principles) is not required. [Paragraph added to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Paragraph renumbered and amended, effective December 1999, by Statement on Auditing Standards No. 88.]

[.10] [Paragraph added to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Paragraph renumbered and deleted by the issuance of Statement on Auditing Standards No. 88, December 1999.]

[.11] [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Paragraph subsequently renumbered and deleted by the issuance of Statement on Auditing Standards No. 88, December 1999.]

Correction of an Error in Principle

.12 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,[5] the change requires recognition in the auditor's report through the addition of an explanatory paragraph. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.][6]

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[5] See paragraphs 13, 36, and 37 of APB Opinion No. 20 [AC section A35.104-.105]. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

[6] [Footnote deleted to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53–62. Footnote renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

Change in Principle Inseparable From Change in Estimate

.13 The effect of a change in accounting principle may be inseparable from the effect of a change in estimate.[7] Although the accounting for such a change is the same as that accorded a change only in estimate, a change in principle is involved. Accordingly, this type of change requires recognition in the independent auditor's report through the addition of an explanatory paragraph. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

Changes in Presentation of Cash Flows

.14 For purposes of presenting cash flows, FASB Statement No. 95, *Statement of Cash Flows* [AC section C25], states that, "An enterprise shall disclose its policy for determining which items are treated as cash equivalents. Any change to that policy is a change in accounting principle that shall be effected by restating financial statements for earlier years presented for comparative purposes." Accordingly, this type of change in presentation of cash flows requires recognition in the independent auditor's report through the addition of an explanatory paragraph. [Paragraph added to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53–62. Paragraph renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

Changes Not Affecting Consistency

Change in Accounting Estimate

.15 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 are 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.[8] 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.[9] [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards

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[7] See paragraph 11 of Accounting Principles Board Opinion No. 20 [AC section A06.110]. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

[8] [Footnote deleted. Footnote renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

[9] See paragraph 33 of Accounting Principles Board Opinion No. 20 [AC section A06.132]. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

Nos. 53 through 62. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

Error Correction Not Involving Principle

.16 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 report.[10] [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53–62. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

Changes in Classification and Reclassifications

.17 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 need to be referred to in the independent auditor's report. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53–62. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

Variations in Presentation of Statement of Changes in Financial Position

[.18] [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53–62. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 88.]

Substantially Different Transactions or Events

.19 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. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982. Paragraph subsequently renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53–62. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

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[10] If the independent auditor had previously reported on the financial statements containing the error, he should refer to section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53–62. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

Changes Expected to Have a Material Future Effect

.20 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 report. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982. Paragraph subsequently renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53–62. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

Disclosure of Changes Not Affecting Consistency

.21 While the matters do not require the addition of an explanatory paragraph about consistency in the independent auditor's report, the auditor should qualify his opinion as to the disclosure matter if necessary disclosures are not made. (See section 431.) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982. Paragraph subsequently renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53–62. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

Periods to Which the Consistency Standard Relates

.22 When the independent auditor reports only on the current period, he should obtain sufficient appropriate audit evidence about consistency of the application of accounting principles, 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 address the consistency of the application of accounting principles between such years and the consistency of such years with the year prior thereto if such prior year is presented with the financial statements being reported upon. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982. Paragraph subsequently renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53–62. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999. Revised, March 2008, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

Consistency Expression

[.23] [Paragraph renumbered and deleted to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53–62. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999.]

First Year Audits

.24 When the independent auditor has not audited 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 to gather sufficient appropriate audit evidence about consistency. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999. Revised, March 2008, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

.25 Inadequate financial records or limitations imposed by the client may preclude the independent auditor from obtaining sufficient appropriate audit evidence about 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 cash flows. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 88, December 1999. Revised, March 2008, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]