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Edward P. Tremper

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CONSISTENCY, COMPARABILITY, and DISCLOSURE

by Edward P. Tremper
Partner, Seattle

In preparing a set of financial statements and our report thereon, questions constantly arise as to whether the statements are "consistent" with those of the prior year, whether the statements are "comparable" with those of the prior year, and whether there is anything not apparent on the face of the statements which should be "disclosed" in order that the statements as a whole be reasonably informative or, as the SEC puts it, in order that the statements be not misleading.

Actually the three standards are so closely related that it is often difficult for an auditor to distinguish which of them is applicable to a given set of circumstances. Consistency is specifically covered by *Generally Accepted Auditing Standards* as the second reporting standard: "The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period." Comparability and disclosure are covered by the third reporting standard: "Informative disclosures in the financial statements

are to be regarded as reasonably adequate unless otherwise stated in the report."

Disclosure is the broadest of the three standards and comparability is next. Both call for the highest degree of judgment in their application. Inconsistency necessarily causes lack of comparability. Thus consistency is always a matter that must be considered for disclosure and comparability, but there are many situations not involving consistency that require application of the standards of either comparability or disclosure or both.

This article deals with the important aspects of each standard and describes their relationships and the areas where they may be distinguished.

CONSISTENCY

Consistency relates to the application of accounting principles and practices in a consistent manner between years. However, accounting principles and practices are not static, nor are the business activities to which they are applied. In many areas there is a choice of alternative principles or practices, one of which may be appropriate under one set of circumstances while another choice is appropriate under another set. The second reporting standard is not intended to prohibit changes in accounting principles nor is it intended to act as a barrier to progress. There should be no deterrent to changes in accounting principles made in good faith with a view to improvement in reporting.

In considering changes in accounting principles, the Securities and Exchange Commission goes further than does *Generally Accepted Auditing Standards* both as to the application of the principles and the opinion of the auditor regarding the change. Regulation S-X calls for "the opinion of the accountant as to any material changes in accounting principles *or practices or method of applying the accounting principles or practices.*" Thus you will note that S-X not only encompasses practices as well as principles but also includes the method of applying them.

Further, S-X requires the expression of the accountants' opinion regarding the change, which requirement is not covered specifically by generally accepted auditing standards. The best practice, however, does call for the expression of approval, acceptance, or disapproval by the accountant. It is well to remember that disapproval of a change would ordinarily call for a qualification, and might, if the amounts

were relatively material, require denial of an opinion on the financial statements taken as a whole.

The materiality of changes in accounting principles should be viewed with both the short- and the long-range effects in mind. Thus, even though the effect in the year of change is not significant, if it is likely to have substantial effects in a later period, or the area involved is important, the change should be appropriately disclosed.

On first examinations by public accountants it is necessary to apply the second reporting standard except in cases where the statements are being presented to outsiders, in non-comparative form, for the first time. In such cases, consistency has no significance to those unaware of a former principle or practice in use. This exception ordinarily applies to smaller companies that previously have not had auditors or have not issued statements to the public. In all other cases, applicable auditing procedures should be applied to the prior year to enable the accountant to express an opinion on consistency.

When a report is made on a balance sheet only, the consistency standard nevertheless applies because the examination necessarily involves an examination of the earnings statement, and also because any change in accounting principle or practice usually would have an effect on the balance sheet itself.

Because of the specific reference in the second reporting standard to consistency with the preceding period, a question arises in cases where financial statements are presented for two or more years. Does the standard require consistency with the year preceding those reported on? If the report covers two years, say 1959 and 1960, any change in accounting principles in the earlier year (1959) from that just preceding it (1958) has already been covered in the prior year's (1959) report. Thus the standard applies only to changes between the two years being reported on. When the report covers more than two years, it takes on some characteristics of a special report and consistency is called for within the period, but not usually in relation to the year prior to those included in the report.

COMPARABILITY

Comparability is an important phase of disclosure and is necessary to make a series of financial statements informative and useful. The

standard always applies where two or more years are reported on, and should be considered in reporting on a single year because of the comparative use that readers may apply. Although changes in accounting principles destroy comparability, there are in addition many cases where comparability is affected by other factors. Before considering these other factors, it should be noted that, although a complete restatement of the prior year or years to disclose the effect of the change may be desirable, useful, or even necessary for comparative purposes, a restatement alone does not cure inconsistency nor satisfy the second reporting standard.

Under the comparability standard, simple changes in account classifications designed to improve statement presentation or more adequately portray changed conditions require a reclassification on a conformed basis for the prior year. A regrouping of accounts on the balance sheet or a change in form in the earnings statement makes comparisons difficult or impossible unless the new grouping or changed form is reflected in the prior year. Comparative statements not conformed one to the other lack usefulness and may even be misleading. When restatements or reclassifications are made, the fact should be disclosed in the statements. Unless the restatement is caused by a change in principle, no reference need be made in the accountants' report.

Comparability may be affected by changes in circumstances or business policy rather than changes in accounting classification or accounting principles. Sometimes such changes are readily apparent. A shift from a cash to a credit sale policy, for instance, probably does not need any other disclosure than that provided by the fact that trade accounts receivable appear on the balance sheet. In other instances separate classification or footnote disclosure is advisable or even necessary to point up the results of the change rather than leave them hidden in omnibus accounts.

For instance, a shift from leasing machinery to customers to outright sale of the same machinery would be disclosed by showing separately revenues from sales and revenues from leasing. In the case of sale of trade accounts receivable, on the other hand, explanation might be difficult except through a footnote.

DISCLOSURE

The third reporting standard contemplates disclosure both in the financial statements and in the accountants' report. The accountants' report must disclose, in the scope section, any failure to apply generally accepted auditing standards. In the event that the financial statements and notes fail to make important disclosures or contain disclosures that are not reasonably adequate, the proper coverage of the matter should be included in the accountants' report.

Disclosure decisions must be made in the light of importance and usefulness of the statements to readers. Disclosure of matters not significant or material serves only to destroy usefulness. Any borderline decisions must be made in the light of the broad disclosure standard. Disclosure of factors not presently material should be made, however, if in the judgment of the auditor they are likely to have importance in the future. Disclosure that might not otherwise be called for may be necessary in presenting comparative statements. Assume that the client acquired during the year a major new subsidiary. The earnings statement for the current year might then need footnote disclosure of the effect of the acquisition on sales and earnings in order not to make it misleading in comparison with the earnings statement of the preceding year.

Disclosure of certain types of post balance sheet events are required by the standard. Under ordinary circumstances, disclosure of a change in accounting principles adopted after the end of the year but before the report is issued is not required because such change will be reported in the following year. However, when it is necessary to disclose a post balance sheet event which is coupled with a change in accounting, the change may require disclosure.

Whenever disclosure is called for, a concise statement of the facts or circumstances should be made. In addition, the effect in dollars is usually of equal importance. In those cases where the effect cannot be precisely determined, every effort should be made to indicate a range. When this is not possible, it is advisable to state the reasons for the inability to assess the monetary effect of the disclosure.

Disclosure is a standard that resists improper changes or those having improper motives because the nature of the change and its effect must be set forth in the financial statements or the accountants'

report or both. The deterrent is effective both as to changes in accounting principles or practices and to changes in form or classification.

The standard of disclosure does not go so far as to require publicizing certain kinds of information that would be detrimental to the client. For example, provision may be made for a claimed liability which the client intends to vigorously oppose and publicity to such a provision might well harm the client's position. As long as reasonable provision is made, disclosure of the amount may serve no useful purpose but might have a detrimental effect on the outcome of the controversy.

* * *

While these three standards are closely related, they can be distinguished, and it is helpful to make distinctions even though cases will arise where all apply. In the broadest sense the standard of disclosure controls, for consistency and comparability are only specific applications of the need to make financial statements useful and informative and the report on them clear. By applying the standards separately to a given set of circumstances, we gain a better understanding of the problem and our opportunity for a sound conclusion is better.

About the author . . .

Edward P. Tremper
Seattle

Born in Seattle, Washington, Edward P. Tremper received his B.B.A. from the University of Washington in 1920 and entered public accounting in the following year. He is very active in professional organizations, particularly the American Institute of Accountants, American Accounting Association, National Association of Cost Accountants and the Washington Society of Certified Public Accountants.