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The Consistency Qualification

A Proposed Solution

By Paul Munter and Thomas A. Ratcliffe

When an enterprise changes accounting principles, and the change materially affects comparability in the financial statements, the auditor's report must be qualified for lack of consistency. However, there exist inconsistencies between the treatment of accounting changes in the audit report and the treatment of accounting changes in the financial statements. The purpose of this paper is to delineate inconsistencies between accounting literature and auditing literature and to propose solutions which will result in a consistent treatment of accounting changes in the accounting and auditing literature.

The Consistency Standard

The second standard of reporting (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.*

The objective of the consistency standard is to give assurance that the comparability of financial statements between periods has not been materially affected by the changes in accounting principles, which include not only accounting principles and practices but also the methods of applying them. Thus, if comparability has been materially affected by such changes, the audit report should make reference to these changes through a consistency exception. Therefore, the purpose of the consistency exception is to provide a "red flag" to alert the readers of the financial statements that the reporting enterprise has made a change in accounting principle.

However, there is a difference between the notion of consistency and that of comparability. Regarding that, paragraph 5 of SAS No. 1, section 420, "Consistency of Application of Generally Accepted Accounting Principles" states that:

> *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 (financial statement) disclosure, but they would not ordinarily be commented upon in the independent auditor's report. (emphasis added)*

Accordingly, the consistency standard is meant to address a change in GAAP as applied by the reporting entity. In determining whether accounting principles are generally accepted, SAS No. 5 "The Meaning of 'Present Fairly in Conformity With Generally Accepted Accounting Principles' in the Independent Auditor's Report" as amended by SAS No. 43 establishes a hierarchy of authoritativeness. Among those documents encompassed by Rule 203 of the Code of Conduct (and thus, at the top of the hierarchy) are Accounting Principles Board Opinions (APBO's). Thus, the source for determining the proper accounting treatment of accounting changes is found in APBO No. 20 "Accounting Changes."

Accounting Changes

APBO No. 20 promulgates current accounting thought concerning how accounting changes should be treated in the financial statements. Exhibit 1 summarizes accounting changes and related items and the proper accounting treatment of these items.

Accounting Changes Affecting Consistency

SAS No. 1, section 420 identifies the types of accounting changes which require recognition in the auditor's report as to consistency. Exhibit 2 summarizes the types of accounting changes and identifies those which affect consistency.

Since the consistency standard makes direct reference to GAAP, a change in an accounting principle (both general type and special type) would require recognition in the auditor's opinion as to consistency. Likewise, since a change in the reporting entity is a special type of change in accounting principle, such a change requires recognition in the auditor's opinion as to consistency. Changes in reporting entity that require recognition in the auditor opinion include:

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.

EXHIBIT 1
Treatment of Accounting Changes

Type of Accounting Change	Treatment in Financial Statements
General type change in principle	Include cumulative effect in income for period of change; do not restate prior periods
Special type change in principle	Retroactively restate all periods presented
Change in estimate	Currently and prospectively
Change in principle inseparable from change in estimate	Change in estimate — currently and prospectively
Change in reporting entity	Special type change in principle — retroactively restate all periods presented
Correction of error	Not an accounting change — prior period adjustment
Change from non-GAAP to GAAP	Correction of error — prior period adjustment
Reclassification	Restate financial statements — e.g., reclassifying a receivable from current to noncurrent

EXHIBIT 2
Impact of Accounting Changes in the Auditor's Report

Accounting Changes	Affect Consistency in the Audit Opinion?
General type change in principle	Yes
Special type change in principle	Yes
Change in estimate	No
Change in principle inseparable from change in estimate	Yes
Change in reporting entity	Yes
Correction of error	No
Change from non-GAAP to GAAP	Yes
Reclassification	No

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

e. A business combination accounted for as a pooling of interests.

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 for accounting purposes (see Exhibit 1). Although this type of change in accounting principle should be accounted for as the correction of an error, SAS No. 1 section 420 requires that this change also be given recognition in the auditor's opinion as to consistency.

As can be seen in Exhibit 1, a change in accounting principle which is inseparable from a change in accounting estimate should be accounted for the same as a change in estimate only. However, since a change in principle is involved, SAS No. 1, section 420 states that this type of change requires recognition in the independent auditor's opinion as to consistency.

Accounting Changes Not Affecting Consistency

As Exhibit 2 shows, the correction of an error in previously issued financial statements resulting from mathematical mistakes, oversights, 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 (i.e., when it is a correction of an error other than a change from non-GAAP to GAAP). Therefore, the independent auditor does not recognize the correction in his opinion as to consistency.

A change in accounting estimate is required by altered conditions that affect *comparability* but does 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, the auditor would not comment on this change in his report because it does not affect his opinion as to consistency. However, a change in accounting estimate which has a material effect on the financial statements may require disclosure in a note to the financial statements. If the effect of the change in accounting estimate is significant enough, the auditor may want to emphasize the matter while still expressing an unqualified opinion on the financial statements. Paragraph 27 of SAS No. 2 "Reports on Audited Financial Statements" allows the auditor to provide such explanatory information in a separate paragraph of the auditor's report (an "emphasis of a matter" paragraph) while still issuing an unqualified opinion.

Lastly, a reclassification of a financial statement element (such as reclassifying the operations of a segment as a discontinued operation) does not involve a change in accounting principle. For purposes of comparability, all financial statements would reclassify this element when

multiple-period financial statements are presented. Since no principle change is involved, a reclassification would not result in a consistency change. Further, if the reclassification involves changing the presentation of funds (e.g., from cash to working capital) in a statement of changes in financial position, SAS No. 43 amends section 420 of SAS No. 1 to treat this as any other reclassification — that is, no recognition as to consistency if all periods presented reflect the reclassification.

The Inconsistencies

From the foregoing discussion, it is apparent that there is a conflict between the accounting treatment and the affect on the audit report for two items: a change in accounting principle which is inseparable from a change in accounting estimate and a change from non-GAAP to GAAP. For purposes of the audit report, both items are treated as a change in accounting principle with a consistency exception reported in the auditor's opinion. Meanwhile, for accounting purposes, neither item is reflected in the financial statements as a change in accounting principle. Since the consistency exception is commonly viewed as a "red flag," this can lead to confusion on the part of the financial statement reader. The reader would expect to find a note explaining the nature, justification, and affects of the change in accounting principle; however, the financial statements would not contain a note for a change in accounting principle.

A Proposed Solution to the Inconsistency in Consistency

As was mentioned earlier, the ASB decided against changing the standard audit report. Thus, the standard audit report still contains a reference to the consistent application of GAAP. Many (if not most) users of audited financial statements look to the audit report for "red flags" that indicate, among other things, changes in the principles used in the preparation of financial statements that impact comparability of those statements over time. However, due to the current inconsistencies between the accounting and auditing literature, it is possible for the audit report to indicate a change in accounting principle has occured when the financial statements do not reflect such a change.

Before a solution to the problem is proposed, it is necesssary to examine the opinion paragraph of the auditor's standard report.

> *In our opinion, the financial statements referred to above present fairly the financial position of X Company as of December 31, 19XX, 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*** *applied on a basis consistent with that of the preceding year. (emphasis added)*

As can be seen, the consistency reference specifically states that the financial statements are prepared in comformity with GAAP applied consistently. APBO No. 20 falls under Rule 203 of the AICPA's Code of Conduct and is, therefore, a part of promulgated GAAP. As was discussed earlier, it is, in fact, APBO No. 20 which defines and illustrates the items which constitute changes in accounting principle.

The consistency exception probably conveys useful information to financial statements readers. Therefore, it would appear to be important to maintain the reference to the consistent application of GAAP in the financial statements for changes in accounting principle.

In order to resolve the inconsistencies which currently exist, a pragmatic solution for reporting all accounting changes and error corrections, other than changes in accounting principle, in the audit report would be to require the use of an "emphasis of matter" paragraph to report these items. (It should be noted that the "emphasis of matter" paragraph is commonly used for material related party transactions, subsequent events, and changes in estimate only.) With this approach, the inconsistencies between the accounting and auditing literature can be reconciled. As was mentioned earlier, emphasis of a matter paragraph is used when the auditor wishes to emphasize some aspect of the financial statements and still express an unqualified opinion on the financial statements taken as a whole. This approach, importantly, would signify that an accounting change has taken place or an error correction has been made without confusing the statement reader

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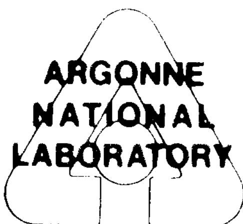

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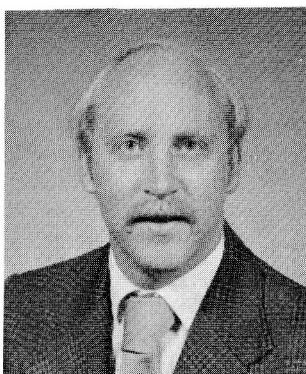
by indicating that the change was a change in accounting principle. Thus, under this proposed solution, when the auditor reports a consistency exception, it will be a "red flag" to financial statement readers that a change in accounting principle is reflected in the financial statements.

Conclusion

While accounting changes frequently take place in practice, the financial statement disclosures used to reflect these changes differ in certain circumstances from the audit report modifications. In this paper, these inconsistent reporting practices between the accounting and auditing literature have been analyzed and a solution to the inconsistencies has been proposed. The ASB has show a willingness to deal with reporting problems on a piecemeal basis (such as SAS No.43). The solution proposed here would enhance the meaning conveyed through a consistency exception while still giving the auditor flexibility in reporting on other accounting changes which are significant to an overall evaluation of the financial statements. Finally, it is a solution which can be adopted within the current audit reporting framework.Ω



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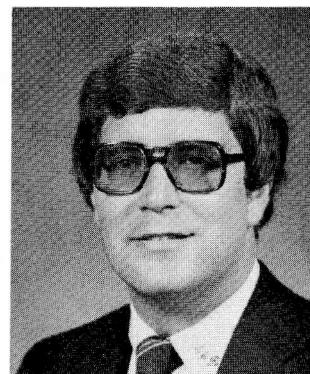

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