AU Section 9420

Consistency of Application of Generally Accepted Accounting Principles: Auditing Interpretations of Section 420 [*]

[1.] The Effect of APB Opinion No. 30 on Consistency[1]

[.01–.10] [Superseded October 1979 by Interpretation No. 5 paragraphs .28–.31.]

2. The Effect of APB Opinion No. 28 on Consistency

.11 *Question*—Independent auditors may be engaged to report on financial information for an annual period and a subsequent interim period. Should the auditor add an explanatory paragraph (following the opinion paragraph) to his report in those circumstances where accounting principles and practices used in preparing the annual financial information have been modified in accordance with APB Opinion No. 28 [AC section I73] in preparing the interim financial statements?

.12 *Interpretation*—No. The auditor should not add an explanatory paragraph to his report because of these modifications. Although the modifications deemed appropriate under Opinion No. 28 [AC section I73] may appear to be changes in the methods of applying accounting principles, they differ from changes in methods that require an explanatory paragraph since the modifications are made in order to recognize a difference in circumstances, that is, a difference between presenting financial information for a year and presenting financial information for only a part of a year.

.13 Section 420, *Consistency of Application of Generally Accepted Accounting Principles*, paragraph .02, states: "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." Section 420 paragraph .02 refers to changes in methods that lessen the usefulness

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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] Originally issued under the title "Reporting on Consistency and Extraordinary Items" (*Journal of Accountancy*, Jan. '74, p. 67).

of financial statements in comparing the financial information of one period with that of an earlier period. Thus, the purpose of an explanatory paragraph about consistency in the auditor's report is to alert readers of the report not to make an unqualified comparison of the financial information for the two periods.

.14 The modifications introduced by Opinion No. 28 [AC section I73], however, do not lessen the comparability of the financial information of an interim period with that of a preceding annual period. On the contrary, those modifications are intended to enhance comparability between the two sets of financial information. As paragraph 10 of Opinion No. 28 [AC section I73.103] states, the modifications are needed "so that the reported results for the interim period may better relate to the results of operations for the annual period."

.15 Thus the modifications introduced by Opinion No. 28 [AC section I73] are not of the type that would require an explanatory paragraph (following the opinion paragraph) in the auditor's report. Independent auditors should, of course, add an explanatory paragraph if changes of the type that lessen comparability are introduced in the interim financial information.

[Issue Date: February 1974.]

3. Impact on the Auditor's Report of FIFO to LIFO Change in Comparative Financial Statements

.16 *Question*—Changing economic conditions have caused some companies to change their inventory pricing methods from the first-in, first-out (FIFO) method to the last in, first out (LIFO) method. When a company presents comparative financial statements and the year of the FIFO to LIFO change is the earliest year both presented and reported on, should the auditor refer to that change in accounting principle in his report?

.17 *Interpretation*—The auditor would not be required to refer in his report to a FIFO to LIFO change in the circumstances described above.

.18 A change in accounting principle usually results in including the cumulative effect of the change in net income of the period of the change. A change in inventory pricing method from FIFO to LIFO, however, is a change in accounting principle that ordinarily does not affect retained earnings at the beginning of the period in which the change was made. (See APB Opinion No. 20, paragraphs 14(d) and 26.)[2]

.19 An example of typical disclosure of a FIFO to LIFO change in the year of the change is as follows:

> "In 1974, the company adopted the last in, first out (LIFO) method of costing inventory. Previously, the first in, first out (FIFO) method of costing inventory was used. Management believes that the LIFO method has the effect of minimizing the impact of price level changes on inventory valuations and generally matches current costs against current revenues in the income statement. The effect of the change was to reduce net income by $xxxx ($.xx per share) from that which would otherwise have been reported. There is no cumulative effect on prior years since the ending inventory as previously reported (1973) is the beginning inventory for LIFO purposes. Accordingly, pro forma results of operations for the prior year had LIFO been followed is not determinable."

.20 Section 420, *Consistency of Application of Generally Accepted Accounting Principles*, paragraph .22 discusses the periods to which the consistency

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[2] AC section A06.122.

standard relates: "When the independent auditor reports on two or more years, he should address the consistency of the application of accounting principles between such years. . . ." For a FIFO to LIFO change made in the earliest year presented and reported on, there is no inconsistency in the application of accounting principles, and comparability between the earliest year and subsequent years is not affected since no cumulative effect is reported in the year of the change. Consequently, the independent auditor need not refer to the change in inventory pricing methods.

[.21–.23] [Paragraphs deleted to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62.]

[Issue Date: January 1975; Amended: April 1989.]

[4.] The Effect of FASB Statement No. 13 on Consistency[3]

[.24–.27] [Withdrawn March 1989 by the Auditing Standards Board.]

[5.] The Effects of Changes in Accounting Principles and Classification on Consistency

[.28–.31] [Withdrawn December 1992 by the Audit Issues Task Force.]

[6.] The Effect of FASB Statement No. 34 on Consistency

[.32–.43] [Withdrawn March 1989 by the Auditing Standards Board.]

[7.] The Effect of FASB Statement No. 31 on Consistency

[.44–.51] [Withdrawn March 1989 by the Auditing Standards Board.]

8. The Effect of Accounting Changes by an Investee on Consistency

.52 *Question*—Does a change in accounting principle by an investee accounted for by the equity method require the auditor to add an explanatory paragraph (following the opinion paragraph) to his report on the financial statements of the investor?

.53 *Interpretation*—Changes in accounting principle affect the comparability of financial statements regardless of whether such changes originate at the investor level or are made solely by an investee.[4] Section 420, *Consistency of Application of Generally Accepted Accounting Principles*, paragraph .02 states: "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."

.54 Thus, the auditor would need to add an explanatory paragraph (following the opinion paragraph) to his report when there has been a change in accounting principle by an investee accounted for by the equity method that causes a material lack of comparability in the financial statements of an investor.

[.55–.57] [Paragraphs deleted to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62.]

[Issue Date: July 1980; Revised: June 1993.]

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[3] [Footnote deleted.]

[4] 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."

[9.] The Effect of Adoption of FASB Statement No. 35 on Consistency

[.58–.63] [Withdrawn March 1989 by the Auditing Standards Board.]

10. Change in Presentation of Accumulated Benefit Information in the Financial Statements of a Defined Benefit Pension Plan

.64 *Question*—FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans* [AC section Pe5] requires the presentation of information regarding the actuarial present value of accumulated plan benefits and year-to-year changes therein of a defined benefit pension plan but permits certain flexibility in presenting such information. The information may be included on the face of a financial statement (a separate statement or one that combines accumulated benefit information with asset information), or it may be included in the notes to the financial statements. Furthermore, the benefit information may be as of the beginning of the period being reported upon or as of the end of that period. Does a change in the format of presentation of accumulated benefit information or a change in the date as of which such information is presented require the auditor to add an explanatory paragraph (after the opinion paragraph) to his report because of the change?

.65 *Interpretation*—Such changes in the presentation of information regarding accumulated benefits are considered reclassifications or variations in the nature of information presented. Changes such as these that are material should be explained in the financial statements or notes, but these changes ordinarily would not require the auditor to add this explanatory paragraph to his report (see section 420 paragraph .17).

[Issue Date: December 1980.]

[11.] The Effect of the Adoption of FASB Statement No. 36 on Consistency

[.66–.68] [Withdrawn March 1989 by the Auditing Standards Board.]

12. The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Change in the Year of Adoption

.69 *Question*—An entity adopts a new accounting standard (for example, Financial Accounting Standards Board Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*) and the standard does not require the entity to disclose, and the entity has not disclosed or determined, the effect of the change in the year of adoption.[5]

.70 Section 420, *Consistency of Application of Generally Accepted Accounting Principles*, paragraph .05 states, in part, that:

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

.71 If an accounting standard does not require the entity to disclose, and the entity has not disclosed or determined, the effect of the change in accounting principle in the year of adoption, how should the auditor determine materiality for purposes of applying the consistency standard?

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[5] Accounting Principles Board Opinion (APB) No. 20, *Accounting Changes*, does not apply to initial adoption of an accounting standard that specifies the manner of reporting the accounting change to conform with the conclusions of that standard. See APB No. 20, paragraph 4.

.72 *Interpretation*—According to section 420 paragraph .02, the objective of the second standard of reporting (referred to in section 420 as 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. [Footnote omitted]

When an accounting standard does not require the entity to disclose the effect of the change in accounting principle in the year of adoption, section 420 does not require the auditor to independently determine the effect of that change in the year of adoption. Therefore, to determine whether to add an explanatory paragraph to the audit report for the accounting change resulting from adoption of such an accounting standard, the auditor should consider (*a*) the materiality of the cumulative effect of the change, where the accounting standard specifies that the cumulative effect of the change be recorded as of the beginning of the reporting period, and (*b*) the entity's voluntary disclosure, and the related support, regarding how it believes the change in accounting principle affected the financial statements in the year of adoption, when such disclosure is made. An explanatory paragraph would be required only if the cumulative effect of the change is material or if management discloses that it believes that the effect is or may be material in the year of adoption.

[Issue Date: April 2002.]