

Date: June 26, 2002

To: Auditing Standards Board (ASB)

From: Gretchen Fischbach

Re: Proposed revisions to AU sections 420, 431, and 508

Background

The ASB's Consistency Task Force was asked to review the guidance in AU section 420, *Consistency of Application of Generally Accepted Accounting Principles*, which interprets the second standard of reporting, and determine whether revisions are needed to that guidance. The second standard of reporting, traditionally referred to as the consistency standard, currently states as follows:

The report shall identify those circumstances in which [generally accepted accounting] principles have not been consistently observed in the current period in relation to the preceding period.

Since October 1961, the objective of the consistency standard has been to ensure that if comparability of an entity's financial statements between periods has been materially affected by changes in accounting principles, there will be appropriate reporting regarding such changes. Auditing standards have always acknowledged that items other than changes in accounting principles affect comparability of the financial statements between periods; however, since the items are not changes in accounting principles, they do not involve the consistency standard and thus do not trigger a reporting requirement for the auditor under that standard. If material, these other items may require disclosure, a matter that falls under the third standard of reporting.

In recent years, some parties have questioned the usefulness of the consistency standard. In its 1978 report entitled *The Commission on Auditor's Responsibilities*, the Cohen Commission recommended eliminating the consistency standard. That report indicated as follows:

However, generally accepted accounting principles now require management to disclose in the financial statements that an accounting principle has been changed. When the requirement to report on consistency was established in 1933, accounting methods and disclosures concerning accounting changes were diverse. Accounting Principles Board Opinion No. 20, adopted in 1971, now specifies the accounting and disclosures to be provided in the financial statements. The Opinion indicates the treatment in current and prior period statements, pro forma calculations that may have to be disclosed in the financial statements, and disclosures required in the financial statements concerning the nature of and justification for the change.

If the accounting and disclosure requirements have been met, the auditor should not have to report that the basis has remained unchanged or has changed. If he reports no change or reports a change, he has crossed the line from evaluator of financial information based on established standards to originator of financial information.

In sum, generally accepted accounting principles now make reporting on consistency management's not the auditor's responsibility. The auditor's proper function is to consider the propriety of management's accounting for changes in accounting principles and the adequacy of management's disclosures concerning consistency in the application of accounting principles, not to report that accounting principles have or have not been consistently applied.

Since the issuance of the Cohen Commission's report, the ASB has twice tried to eliminate or amend the consistency standard. In 1987, the exposure draft for SAS No. 58 eliminated from the auditor's report the consistency reference on the basis that generally accepted accounting principles now require disclosure of changes in accounting principles. According to the ED, when the consistency standard was adopted, no formal accounting rule existed for maintaining consistent application of accounting principles or for accounting for changes and disclosing them in the financial statements. The SEC opposed elimination of the consistency standard because the standard was perceived as useful and in the public interest.

More recently, the ASB tried to revise AU section 420 to require an explanatory paragraph only when there have been discretionary changes in accounting principles. This was partly in response to the increase in the number of report modifications for changes in accounting principles and the result of accounting studies that found that companies "make discretionary changes to increase net income, respond to poor performance trends, increase management compensation, avoid debt covenant violations, save on taxes, and mitigate political or regulatory costs."

Although the SEC favored eliminating the requirement to report on *mandatory* changes in accounting principles, the Association for Investment Management and Research (AIMR) opposed the change. In a letter to the AICPA, AIMR, which represented about 33,000 members at the time, stated as follows regarding the explanatory paragraph:

It serves as a red flag for financial statement users. When mandatory changes have long adoption windows (sometimes up to three years), such a flag alerts users as to when the mandatory change has been adopted. This flag also serves to inform those users of financial statements who do not keep abreast of accounting developments that a new standard has been implemented.

The project was discontinued based on AIMR's letter.

At a liaison meeting between the AITF and the SEC in 2001, the SEC Chief Accountant asked whether ASB planned to reconsider eliminating the explanatory paragraph for mandatory changes in accounting principles. AITF discussed the matter and approved forming a task force to review and, if necessary, update the guidance in AU section 420.

Task force members include Craig Crawford (Chair), Jeff Bryan, Al Paulus, and Mark Scoles.

The Task Force's Proposal

The task force met on June 6, 2002. During that meeting, members discussed (a) the requirements of AU section 420 and APB Opinion No. 20, *Accounting Changes*, (b) investor's/user's needs in today's environment, (c) how best to serve the public with respect to changes in accounting principles, and (d) AIMR's rejection of the previous effort. After discussion, the task force concluded as follows:

1. It is in the public interest to report on *voluntary* changes in accounting principles.

GAAP is set by organizations designated by AICPA council to set accounting principles under Rule 203 of the AICPA's "Code of Conduct." To be designated as a standards setter under Rule 203, an organization must comply with established criteria that, among other things, require the standard setter to be independent from undue influence of its constituency.

The organizations currently designated to set GAAP issue standards that are designed to improve financial reporting and enhance comparability of financial information. Various oversight organizations as well as financial statement preparers, investors, and other interested parties provide input during the development of accounting standards. Once a standards-setting organization issues a new accounting standard, entities must adopt the new standard for matters falling within the scope of the standard.

Because of the process used to designate an organization as a standards setter and the process the standards setters use when issuing new accounting standards, as described in the preceding two paragraphs, the task force believes that reporting on changes in accounting principles mandated by the standards setters (i.e., mandatory changes) is *not* useful to the public. Therefore, it recommends eliminating the requirement to report on changes in accounting principles for those changes that are mandatory. In addressing AIMR's concerns, the task force noted that accounting principles with long adoption windows are relatively rare. Also, if a user has not kept abreast of accounting developments, he or she generally will not benefit from the "red flag."

The task force, however, reached a different conclusion regarding *voluntary* changes in accounting principles. Unlike a mandatory change, a voluntary change in accounting principle is not subject to "due process," input from regulators and users of financial information, or public scrutiny prior to management effecting the change. Rather, a voluntary change is one made at the discretion of management, which is not independent from the entity and may be subject to

“extreme pressures...to achieve earnings, revenue or other targets.”¹ Also, as stated previously, accounting studies indicate that some discretionary changes, are made to “increase net income, respond to poor performance trends, increase management compensation, avoid debt covenant violations, save on taxes, and mitigate political or regulatory costs.”

Because of the pressure on management to present a favorable financial “picture” and because the public does not have input or oversight capability over these changes before management makes them, the task force concluded that reporting on voluntary changes is more useful to the public. Additionally, with the proliferation of recently issued accounting standards, and the expectation of more to come, the task force believes that limiting the auditor’s reporting responsibility to voluntary changes is beneficial to the public because it ensures that the voluntary changes are not “overshadowed” by the growing number of mandatory changes. Knowing when management has made voluntary changes in accounting principles will allow users of financial statements to focus on the rationale for those changes and better evaluate not only the financial information presented but management and the company’s performance.

2. The new guidance should be clearer and easier to understand and implement than the guidance currently in AU section 420 (see attached electronic file: *Changes in Accounting Principles.doc*)

The guidance in AU section 420 was based on APB Opinion No. 20. For that reason, it contained detailed discussions of all accounting changes and the reasons why they did or did not require reporting under the consistency standard. Additionally, the guidance in AU section 508.18 seemed to be at odds with some of the guidance in AU section 420.

The task force therefore proposes guidance that will replace the current AU section 420. That new guidance is based on the following:

- The second standard of reporting will apply to *all* voluntary changes in accounting principles that have a material effect on financial statements regardless of how management accounts for the change. The guidance will not refer to material comparability (for which there are no criteria). The task force proposes revising the second standard of reporting to read as follows:

The report shall identify, in the year of change, voluntary changes in accounting principles that have a material effect on the financial statements. For years subsequent to the year of change, the report shall continue to identify the voluntary changes only if comparability between financial statements presented is affected.

¹ See Public Oversight Board’s Panel on Audit Effectiveness *Report and Recommendations*.

- Because the accounting literature links consistency only to changes in accounting principles, the guidance in the new AU section 420 will be limited to changes in accounting principles. Other accounting changes fall under the reporting standard.
- The auditor will continue to report on the changes only if the year of change financial statements are presented *and* comparability between years presented is affected.
- The standard does not preclude an auditor from reporting on mandatory changes if the auditor believes that such reporting is beneficial to the users of the financial statements.
- The standard will remind auditors that they must evaluate changes in accounting principles to make sure that:
 - The newly adopted accounting principle is a generally accepted accounting principle
 - The method of accounting for the effect of the change is in conformity with generally accepted accounting principles, and
 - Management’s justification for the change is reasonable.

3. Need to amend SAS No. 58, *Reports on Audited Financial Statements* (see attached electronic file: *Proposed Amendment to SAS No. 58.doc*)

The task force recommends revising the section beginning at AU section 508.16. The changes are as follows:

- Change the title of the section to *Reporting Changes in Accounting Principles*.
- Revise, as needed, the guidance in AU section 508.16 through 508.18 and include those paragraphs under the subtitle *Voluntary Changes in Accounting Principles*.
- Add a paragraph containing reporting guidance for corrections of errors involving accounting principles. This is not an accounting change, but involves a change in accounting principle, or the method of applying that principle, and the task force believes that it is important enough to require reporting of the correction (reporting is currently required under AU section 420). This paragraph should appear under the subtitle: *Correction of an Error Involving a Change in Accounting Principle* within the *Reporting Changes in Accounting Principles* section.

4. Need to amend AU section 431, *Adequacy of Disclosure in Financial Statements* (see attached electronic file: *Amendment to AU Section 431.doc*)

The guidance in AU section 431 is premised on *omissions* from the financial statements. The task force recommends revising the guidance in AU section

431.03 to include *misstatements* in addition to omissions. This is consistent with the definition of materiality that is in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*. FASB Concepts No. 2 defines materiality as “the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.”

Expected ASB Action

C. Crawford will present the task force’s proposed documents at the July 23-24, 2002 ASB meeting. He will ask members to discuss the proposal to require reporting on voluntary changes in accounting principles only. He also will ask members for feedback on the other proposed changes that the task force believes are necessary to properly reflect the change to the reporting standards from reporting on all changes in accounting principles to reporting only voluntary changes.